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BUSINESS AND PERSONNEL OPPORTUNITIES

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BUSINESS OPPORTUNITIES

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BOOK REVIEWS

Shirtsleeve Economics

By William A. Paton. APPLETON-CENTURY-CROFTS, INC. New York, N. Y., 1952. Pages: xix + 460; $4.00.

Professor William A. Paton, having achieved an eminent position in accounting, attempts, in the work under review, to deal with economic concepts and issues with which the layman grapples, many times vaguely and uncertainly, in every-day thought and conversation.

The topics covered include the following: war and economic progress; soldiering by employees; welfare expenditures by government; the trend toward reducing class and regional inequality; taxes and capital formation; the forcing of corporate distributions of earnings; private versus state control of productive facilities; the "buy-at-home" theory; the significance of foreign trade on domestic economic well-being; loans and grants to foreign countries; the "dollar shortage;" immigration restriction; inflation; the devaluation of the dollar; the gold standard; government control of pricing and rents; the government's farm program; fair trade legislation; price cutting and competition; double taxation of investor income; deficit spending; administration of the federal old age fund; corporate pension plans; the effects of the shorter work week and minimum wage rates; and collective bargaining.

Paton also discusses some matters which are of direct interest to the accountant, as follows: the need for correcting the retained earnings account for erroneously accumulated depreciation; the stock dividend as a means of reinvesting earnings; and the inadequacy of a depreciation charge based on historical cost in a period of inflation. On this last point, he cites the recommendation of the Committee on Concepts and Standards of the American Accounting Association, to the effect that management may include in stockholders' reports "supplementary statements which present the effects of the fluctuation of the dollar upon net income and financial position."

The central proposition of the book is that the economy cannot consume any more than it produces, and that only through increased production is a higher standard of living possible. As an important corollary, influences and developments which tend to limit or discourage production should be checked. Paton regards social legislation and government regulation as the primary factors retarding production. He attributes the high level of productivity and welfare achieved in this country to private enterprise, which he defines as "a system under which there is individual freedom of choice in economic activity,

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fostered by a limited, democratic form of government, and implemented by the mechanism of the competitive market."

Paton believes that the function of government "is that of seeing to it that the individual is free to make choices rather than of forcing him to accept the state's choices." He both deplores and assails the disregard of this function, and the increasing intrusion of government in economic activity. At one point, obviously with tongue in cheek, he recommends that, if the government must engage in business, it might well go into the undertaking field:

"If it is desired to have further experimenting in government operation of business undertakings I have a candidate to suggest. Instead of setting up additional TVA's and other government utility enterprises let's give government a crack at the undertaking and cemetery business. Here's a field—burying people—that might conceivably be handled more economically by government monopoly than by private concerns. Of course this would probably introduce a considerable degree of standardization and drabness, but curbing the desire of relatives to squander money on lavish funerals for the deceased would hardly be an intolerable interference with personal liberty. *And since deceased people have no vote the danger that the enterprise would become primarily a vote-coddling device would be lessened.* By undertaking undertaking, moreover, government would be adding a nice touch in the direction of implementing the 'security-from-cradle-to-grave' slogan. The state's traditional interest in births and deaths could also be used as an excuse for taking over in this area."

At another point, Paton takes the politicians and the government to task in the following typical statement:

"For twenty years most politicians—of both parties—have been feeding the public, by radio and otherwise, a lot of economic nonsense. There has been a continuous hammering on two related themes. First, the small, selfish group of business men standing between the masses of the people and the good life—fine houses, bathtubs, cars, and all the other fixings—must be brought to heel or liquidated. Throughout this period business men and business organizations have been the *bete noire*, the symbol of wickedness. Second, all that is necessary to settle the hash of big business and provide security and a high standard of living for all is appropriate governmental action. And the beauty of it is that these increased blessings can be had by beginning work later in life, working less hours per week, and retiring at 65 or earlier. There will be no need for the individual to plan, to hustle, to worry; the

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government will take care of everything. Moreover, the government can do all this while controlling and restricting (and destroying) farm output and discouraging business activity through punitive taxation and other harassing tactics. What a pipe dream!"

Paton's style is pungent and highly readable. His expression is forceful and positive, without, to use his own phrase, "the usual pussyfooting." The abstractness which characterizes some of his accounting works is almost entirely absent. He indulges frequently in anecdotes which strike home in that they conform to the reader's own experience. He documents his work with statistics and excerpts from addresses and writings which effectively develop his thesis of free enterprise unmolested by government intervention.

One might criticize Paton's almost exclusive use of the quantitative approach. At times, he ignores entirely political and social aspects which cannot be readily or properly assayed on a statistical basis. Yet, on the whole, if one is looking for entertainment and enlightenment, and a clear, forceful defense of free enterprise, *Shirtsleeve Economics* thoroughly fills the bill. Accountants will have a special interest in this work since it gives them an insight into the economic, social, and political philosophy of one of their acknowledged leaders.

JOSEPH A. MAURIELLO

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New York University

Accounting Procedure for Standard Costs (Revised Edition)

By Cecil Gillespie. THE RONALD PRESS COMPANY, New York, N. Y., 1952. Pages: xix + 472; $7.50.

The author, Professor of Accounting at Northwestern University and a Certified Public Accountant, possessing more than twenty years of teaching and practical experience, sets forth an authoritative treatise on standard costs. Systematically and methodically, he presents the subject matter in a well-organized manner, employing 163 illustrations relative to the data which are discussed. If an illustration could be formulated to assist the reader it is displayed, thereby affording visual benefit.

The contents include: 14 chapters; 4 case studies; a glossary; 163 illustrations, with a section of questions and problems applicable to each chapter. Therefore, this publication serves in a dual capacity: as a text for a course of study in Standard Costs and as a dependable source reference in a specialized field.

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／THE NEW YORK
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EMANUEL SAXE, *Managing Editor*

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Accounting for Magazine Publishers

By REINHOLD DREHER, C.P.A.

This paper considers briefly some of the accounting, auditing and record-keeping problems and techniques peculiar to the accounts of magazine publishers.

Survey of the Industry

The field of magazine publishing is broad and magazine subject matter embraces almost all of man's activities on earth as well as more or less imaginative portrayals of what awaits future generations both on earth and in what is referred to as "space."

According to Funk and Wagnall's dictionary, the first magazine published was "The Gentleman's Magazine", issued in London in 1731, and a magazine is defined as

> "A periodical publication containing stories, sketches, essays and the like, and often illustrated."

A periodical has been defined by the courts as follows:

> "A periodical, as ordinarily understood, is a publication appearing at stated intervals, each number of which contains a variety of original articles by different authors, devoted either to general literature of some special branch of learning or to a special class of subjects. Ordinarily each number is incomplete in itself and indicates a relation to prior or subsequent numbers of the same series. It implies a continuity of literary character, a connection between the different numbers of a series in the nature of the articles appearing in them, whether they be successive chapters of the same story or essays upon subjects pertaining to general literature."

Magazines may be classified by frequency of publication, as weekly, bi-weekly, monthly, bi-monthly, quarterly, and annual; or by type, i.e., "slicks", pulps, news magazines, comics, digests, business, farm or trade papers, professional journals, house organs, Sunday supplements, etc. A publisher may publish only one magazine, or a group of magazines, or in the case of the house organ and certain other papers, publication may be by a department of another organization, for example an oil company, a professional society, a charitable organization, a college, etc.

The major revenue sources are circulation revenue, advertising revenue, and sundry revenue. Circulation revenue comprises sales made at newsstands and subscription sales, the latter

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This paper was presented at a technical meeting of the Society held on May 14, 1952, under the auspices of the Committee on Graphic Arts and Allied Industries Accounting.

being subdivided into direct subscriptions, sales through agencies, and sales through the publisher's own field selling organization. Sundry revenue includes foreign sales, old copy sales, royalties, movie and television rentals and royalties, republication rights, books, "one shot" publications, anthologies, reprints, cuts and engravings.

The publisher's organization and accounting problems will depend to a large degree on the number and kind of magazines published, the following being the major functional divisions of the publishing business:

- Newsstand selling
- Subscription fulfillment
- Circulation promotion
- Advertising—selling, research and production
- Art department
- Editorial department
- Manufacturing (comprising composition, printing and binding)
- Shipping and delivery
- General administration

These operations, or parts of them, may be performed by the publisher's own organization or by outside organizations. Newsstand selling, research and promotion, foreign sales, and the manufacturing operations are most frequently delegated to outside organizations which specialize in these fields. It is possible to publish a magazine almost entirely by the use of outside agencies while, on the other hand, a few of the larger publishers perform all of the operations themselves, or through subsidiary companies.

These two opposing trends, i.e., integration on the part of the larger publishers and the use of independent specialists by the smaller publisher, are based primarily on cost and efficiency factors. Sound cost determination by the accountant is essential to the publisher in determining those functions which he can perform most economically himself and those which it is wiser to delegate to outside agencies.

From the foregoing outline it will be noted that the problems which the accountant will encounter in a particular situation will depend to a large degree on the nature of the publisher's organization. "Farming out" any particular function, such as newsstand distribution, advertising sales, printing or subscription fulfillment also involves all of the related accounting problems.

Theory of Accounts

While business papers, college, professional and like journals have many problems in common with other publishers, this paper will be limited to a discussion of the accounting problems of the general magazine publisher. Before proceeding to that discussion, it should be pointed out, in passing, that trade and business papers have made considerable progress in standardization of account classifications and statement presentation. Uniformity has been built around a three-way classification of income and a five-way classification of expense with, in each case, subdivision of accounts into appropriate sub-accounts. In this field of publications income is divided into:

- Advertising Revenue
- Circulation Revenue
- Service Revenue

and expenses are segregated as follows:

- Mechanical and Distribution
- Advertising
- Editorial
- Circulation
- Administrative

General publishers, other than business paper houses, follow this general outline to a certain degree, but variations from it are numerous and result from variations in the nature of the publication or the functional organization of the publisher.

Basic in the determination of the net income of the general publisher is the matching of the direct revenues with the direct costs and direct expenses applicable to each issue of each

publication. A simple illustration will serve to outline this principle.

Let us take the case of a publisher who publishes only one monthly general consumer magazine which derives income from circulation, advertising and the usual sundry revenue sources. Let us further use the May issue as an example. (While the dates mentioned below will vary somewhat as between different monthly publications, the variations do not alter the broad principle involved.) Work on the May issue will probably have been started by the editors in January, some manuscripts having been purchased before that date. The advertising department will have sold space on contracts in January or earlier. This May issue will probably be "closed" by March 15th (that is editorial and advertising matter will be in final shape). The issue will be printed during the last week of March and shipments to newsdealers will commence immediately. Advertising bills will be rendered during April. The May issue will be placed "on sale" on the newsstands on April 10th and will come "off sale" on May 10th. Unsold copies, covers or cover strips will be returned by the newsstand to the local distributor who, in turn, will return them to the national distributor who will charge the publisher's account as the returns are received during the period from May 10th until July 10th. When are these transactions, which occurred between January and July 10th, reflected in the income account of our hypothetical publisher?

Generally speaking, the May issue has been published in April (it went "on sale" on the newsstands on April 10th)—and direct income and expenses attributable to the May issue are treated as income and expenses for the month of April. Accordingly, the income statement of our hypothetical publisher for the month of April will generally include the following:

Circulation Revenue from Newsstand Sales will include the entire billing of the May issue—less all estimated returns—regardless of the fact that some of the magazines will have been shipped during March and regardless of when the returns are actually received or charged to the publisher's account by the distributor. In addition, the difference (either gain or loss) between the estimated returns and actual returns of the February issue will be reflected in the income statement for the month of April since all returns will usually have been received by April 30th.

Circulation Revenue from Subscriptions will include the pro rata share of deferred subscription revenue applicable to the May issue whether the subscriptions were received during, or prior to the calendar month of April and regardless of whether the subscribers' copies were mailed in March or April.

Advertising Revenue for the month of April will include the billing price, less agency commissions, of advertisements appearing in the May issue, regardless of when the contracts for space were executed and regardless of when the space was billed to the advertiser although, in most cases, the billing date coincides with the publication date.

Sundry Revenue on the other hand, for the month of April, will include income actually received or accrued in that month irrespective of the issues to which they apply. For example, a limited number of copies of the January issue may have been shipped overseas. This billing may be made in April and included in April revenues.

Mechanical and Distribution Expenses for the month of April will include the cost of paper used and composing, printing, binding and shipping charges for the May issue.

Advertising Expenses for the month of April will include all expenses incurred during that month, regardless of the issue to which they relate. A frequent exception is that advertising

salesmen's commissions (as distinguished from salaries) will be accrued as an April expense if they relate to the May issue.

Editorial Costs for the month of April will include:

(a) Manuscripts, cover paintings, engravings and major art work relating to the May issue.

(b) Editorial salaries and other expenses incurred in April regardless of the issue to which they apply. (The editors for example will at this time be working on a number of future issues.)

Circulation Fulfillment and Promotion Expense for the month of April will include all salaries and other expenses incurred in the month of April regardless of the issue which is then being fulfilled or to which promotion efforts may relate. An exception is the case in which certain circulation expenses are deferred as will be discussed later.

General and Administrative Expense will include all expenses of this type which were incurred in the month of April.

From the foregoing it will be noted that the income statement of our hypothetical publisher for the calendar month of April will include generally the circulation and advertising revenue, manufacturing, distribution, and some editorial costs of the May issue and all other revenues accrued or expenses incurred in April, regardless of the issue to which they apply.

The Balance Sheet

The balance sheet of a magazine publisher will usually reflect some or all of the following items which are peculiar to the publishing field:

Accounts Receivable

This caption will include where applicable (a) accounts receivable from newsdealers, regional distributors or a national distributor; (b) accounts receivable from advertisers, usually net of agency commissions; (c) sundry accounts; and (d) sometimes accounts receivable from subscribers for subscriptions sold on a deferred payment basis. Usually, however, this latter amount is not carried as a receivable and the offsetting credit is not included in deferred subscription income.

Provision for Estimated Returns

This amount is usually reflected as a reduction of accounts receivable, and represents an estimate of the billing price of magazines which have been shipped to newsdealers or distributors, which they are privileged to return for credit if not sold. Where freight charges on returns are substantial, the estimated amount of such charges is often included in this "reserve" account. The distribution of magazines on a national basis involves a considerable time lag in the return of unsold magazines from the newsstand to the national distributor so that in the case of a monthly magazine, this item will usually include estimated returns for two or more issues of each magazine published prior to the balance sheet date. The amount of this item will usually be determined from ledger accounts which are carried for each issue of each magazine published and which were credited, when the issue went "on sale", with the circulation department's estimate of expected returns and which were charged with actual returns received. The remaining balance must be reviewed and checked with revised estimates of the remaining expected returns as of the balance sheet date. When the period for the return of unsold copies has expired, the balance remaining in the "reserve" account is closed out to sales and reflected—usually as a separate item—on the income statement of the publisher for the month in which the "reserve" is closed out.

Provision for Advertising Rebates

This item should be shown either as a reduction of accounts receivable or as a current liability, depending on the facts in the particular case. The latter treatment is appropriate where the rebates are due to advertisers who have no current balances owing to the publisher. Determination of the amount of rebates due because of multiple insertions and consequent reduced space rates presents no unusual problems.

Other rebates due to advertisers arise from the trade practice of guaranteeing to the advertiser that the circulation of a magazine will not be less than a certain number of copies—called the "guaranteed net paid circulation". In the event that circulation does fall below the guaranteed figure a rebate of a portion of the billing price for the space is refundable to the advertiser. In making a determination of the provision for these rebates, circulation figures of the Audit Bureau of Circulations or Controlled Circulation Audit, Inc., are used and trade practice or the publisher's practice must be followed in determining whether the guaranteed circulation is the average for a specified period or the average for the particular issues in which the advertiser's copy appears. Furthermore, while the billing price for the space which has been recorded on the publisher's books may be a net amount —that is the space rate less the discount allowed to the advertising agency —the rebate will usually be made at the space rate.

Art Work and Manuscripts

This item is usually carried at the specific cost of each piece of work and will represent material which has not, at the balance sheet date, been used in a published issue. Minor items, such as inexpensive contributions, cartoons, photographs, cuts, etc., may be charged to editorial or advertising expense, as applicable, when purchased and will not be reflected in this caption, chiefly because the record-keeping costs do not warrant a more accurate treatment.

Art work and manuscripts are frequently purchased many months in advance of publication and for many reasons may not ultimately be used. Auditors must accordingly analyze this item periodically to determine that unusable material is eliminated. Due to the considerable volume of this material in larger publishing organizations, and the difficulty, in many cases, of devising effective internal control procedures, art work and manuscript purchases require extra vigilance to detect possible irregularities. The mailing to authors and artists of Federal information returns on Form 1099 directly by the accounting department or the independent auditor will be of considerable assistance in detecting possible fictitious purchases of art work and manuscripts.

Paper

This item presents no unusual problem. In most cases paper is located at an outside printer's plant and verification by confirmation is satisfactory. Many publishers purchase their paper requirements under long-term contracts which should be reviewed by the auditor.

Costs Relating to Issues Not Yet Placed On Sale

This item will include engravings, composition costs, printing and binding charges, etc., relating to issues which have been partially completed and is approximately in the same category as "work-in-process" in other fields.

Copyrights, Trademarks, Subscription Lists, Magazine Titles, Advertising Contracts and Goodwill

This item, probably the most valuable in any publishing business, is most often valued at $1.00 although purchased goodwill, etc., applicable to acquired magazines or subscription lists is often capitalized and sometimes

amortized over a period of years. Magazine names, and sometimes special departments or features incorporated therein, are registered as trademarks in the United States Patent Office. Customary practice is to secure United States copyright on each issue of each magazine and in many cases foreign copyright is also secured.

Prepaid Royalties and Advances to Authors

This category is self-explanatory and it can usually be verified by ordinary auditing procedures. Attention must be given particularly to proper treatment of minimum guaranteed royalties and advances to authors who may not produce usable materials.

Deferred or Prepaid Circulation Expenses

In theory, a distinction should be made between expenditures to maintain circulation (which are an expense), and expenditures made to increase circulation (which represent the cost of an addition to the circulation structure, which is a valuable publishing property).

This theoretical distinction is difficult to make and in practice most publishers charge all expenditures for circulation promotion to expense as they are incurred, regardless of whether they maintain or increase circulation.

Occasionally these expenses are deferred and an effort is made to "match" them with revenue by a charge to income in the accounting period in which the related subscription revenue is credited to income.

Newsdealers' and Agents' Cash Bonds

This comprises deposits made with the publisher as security and presents no unusual accounting problem.

Deferred Advertising Revenue

This caption represents advertising revenue collected by the publisher for advertisements which will appear in issues to be published after the balance sheet date.

Deferred Subscription Income

This item is usually presented on the balance sheet, together with deferred advertising revenue, in a separate category below current liabilities and represents the prorated revenue received from subscribers, or the net revenue received from subscription agencies, applicable to copies of issues to be published after the balance sheet date.

In certain fields of publishing, subscription revenue is taken into the income account when received. However, where this item is material in amount it is usually treated on a deferred basis. There are a number of methods currently in use, the general treatment being to credit the proceeds of sale to unfilled subscription accounts at the time of sale. These accounts are adjusted for cancelled subscriptions and, at the time of delivery of the publication to the subscriber, or when the magazine goes "on sale" on the newsstand, there is transferred from the unfilled subscription accounts to the income account, the revenue allocable to the filled subscriptions, based on the ratio between the number of subscriptions filled and the aggregate number of subscriptions unfilled.

The determination of the amount of this item, which is in many cases substantial with relation to the other items on the balance sheet, and very material with respect to the determination of the net income of the enterprise, presents many problems of record-keeping which will be discussed later in this paper. Given adequate records, this item can be verified by normal auditing test-checks. However, where the amount is material and the records are not adequate or test-auditing reveals major differences, a satisfactory determination of the amount of this item can only be made by analysis of each subscription on the list. By reference to the termination dates, a deter-

mination is made of the remaining copies to be fulfilled, which amount is multiplied by the average revenue per copy taken from the records of subscriptions received prior to the balance sheet date for a representative period of time. This procedure is extremely costly. It is advisable only

(1) where the amount of the liability is significant and

(2) where the records are clearly incorrect, or

(3) to supply a starting point for adequate records.

In other cases it is used only occasionally, for example every five years or more.

Chart of Accounts

It has already been noted that there is a lack of uniformity in the functional organization of general magazine publishers—that is in the extent to which various publishers "farm out" various operations. There are further variations within departments of a publisher; for example, the editorial staff engaged in publishing a number of magazines may be organized on the basis of assigning one editor to each magazine, or on the basis of "pooling" all editorial work without assignment of particular persons to particular magazines. The accounts, of course, should be set up on the basis of the publishers organization; for example, in the first instance cited above, it is possible to charge editorial salaries to each magazine.

With this in mind there is presented below, instead of a chart of accounts, a list of accounts and major account classifications. With this list and a particular publisher's organization chart as a basis, the usual methods of classification and sub-classification, and the use of an appropriate numbering system will produce a chart of accounts "tailored" to suit the publisher's functional organization.

Assets

Petty cash funds
Cash on deposit
Marketable securities
Accounts receivable—advertisers
  Provision for bad debts
  Provision for rebates
Accounts receivable—subscribers
  Provision for bad debts
Accounts receivable—newsdealers and agencies
  Provision for bad debts
  Provision for rebates
  Provision for returns
Notes receivable
Accrued interest receivable
Royalties receivable
Accounts receivable—employees
Accounts receivable—others
Inventory—Paper
Inventory—Ink
Inventory—Other printing supplies
Inventory—Work-in-process
Inventory—Manuscripts
Inventory—Art work and photos
Inventory—Other
Accounts receivable—affiliated companies
Securities of affiliated companies
Land
Buildings
  Provision for depreciation
Leasehold improvements
  Provision for amortization
Machinery and equipment
  Provision for depreciation
Motor vehicles
  Provision for depreciation
Office furniture and fixtures
  Provision for depreciation
Trademarks, goodwill, subscription lists, etc.
Prepaid insurance
Prepaid taxes
Prepaid royalties
Prepaid and deferred circulation promotion expenses
Other prepaid and deferred charges
Post office deposits
Other deposits receivable
Advances to authors

Liabilities and Capital

Notes payable
Accounts payable
Royalties payable
Dividends payable
Employee payroll deductions
Employer payroll taxes payable
Accrued commissions payable
Accrued salaries and wages payable
Accrued Federal income tax
Accrued State taxes
Accrued City and local taxes
Accrued Interest payable
Accrued expenses—other
Deposits payable—newsdealers
Deposits payable—other
Bonds payable
Mortgages payable
Deferred subscription revenue
Deferred advertising revenue
Deferred income—other

Capital stock
Capital surplus
Earned surplus
Surplus adjustments
Profit and loss

Revenue Accounts

(a separate group of revenue accounts is usually provided for each magazine with provision for a further sub-division in the case of advertising and circulation revenues by issue)

Advertising revenue—(sub-divided as applicable into: display; classified; legal; covers; inserts; color; etc.)

Circulation revenue—(sub-divided into: newsstand; chain stores; railway stands; office; mail subscriptions; agency subscriptions; field staff subscriptions; etc.)

Other revenue—(sub-divided into: royalties; old copy sales; movie rights; television rights; republication rights; books; reprints; cuts; engravings; etc.)

(*Note:* Expenses directly related to production of sundry revenue are often charged directly to the revenue accounts or to underlying sub-accounts and this revenue is reflected on the income statement net of the direct expenses.)

Expense Accounts

(a separate group of expense accounts is usually provided for each magazine, with provision for a further sub-division in the case of direct expenses by each issue. Sub-classification by branch offices or plants are also customary where applicable)

Major expense classifications comprise:

Manufacturing and production
Art
Editorial
Circulation—Newsstand
Circulation—Subscription fulfillment
Circulation—Promotion
Advertising—Research
Advertising—Production
Advertising—Selling
Shipping, handling and distribution
General and administration

The foregoing major classifications are analyzed by sub-accounts such as the following:

Paper
Ink
Manuscripts
Engravings, cuts and plates
Photos
Cartoons and illustrations
Art work
Cover paintings
Composition
Press work
Binding
Stencils and plates
Postage
Freight
Express
Wrappers
Salaries and wages
Commissions
Rent

Heat, light and water
Telephone and telegraph
Payroll taxes
Other taxes
Insurance
Supplies
Maintenance and repairs
Depreciation and amortization
Subscriptions and dues
Professional services
Research and marketing services
Promotion and publicity services
Premiums and prizes
Entertainment
Travel
Bad debts
Collection expense
Donations

Other Income and Expenses

Discounts received
Dividends received
Interest income
Other income
Discounts allowed
Interest expense
Other expense

Special Record Keeping Problems

These are encountered chiefly in the case of larger publications and publishers who publish a large number of titles where the volume, and other factors, require more detailed and accurate data either for operating or control purposes.

Art and Editorial Inventories

One method for the accounting and control of these items which has proved satisfactory is to have the editorial or art department, when purchasing art work or manuscripts, draw a requisition in triplicate which serves as the basis for drawing the check in payment. The original when filed in the accounting department becomes the perpetual inventory record of art work, being withdrawn from the file when the art work is used, at which time it is attached to the journal entry crediting the art or editorial inventory account.

The duplicate is retained by the editorial department for their records, and the triplicate is filed by author or artist as a record for use in preparing information returns, etc., and as a cross index.

Printing Plant Records

Where a printing plant is operated by the publisher, records are required enabling a determination of cost for each publication printed. Either a job cost system or a standard cost system should be used depending on the circumstances.

Art Departments

Publisher-operated art departments require cost determination for art work produced based on time cards or use of predetermined standard costs to enable proper charges for work performed for individual magazines, or for promotion material for the advertising or circulation departments.

Deferred Subscription Income Record

Often this information can be satisfactorily determined from a simple columnar record, one column relating to each future issue. As subscriptions are received they are prorated over their term of fulfillment both as to number of copies and the average revenue. The total of the column for any particular issue will represent the income for that issue and is transferred, on publication, to the subscription income account.

Circulation Records

In the case of the larger publisher, circulation accounting and the accounting and record keeping for subscriptions and subscription fulfillment are involved matters beyond the scope of this paper. Present trends, where large volume is encountered, are in the direction of machine accounting with a good deal of emphasis on punched card and "electronic systems" which are par-

ticularly adapted, for example, to the maintenance of subscribers records for use in billing, preparation of mailing lists, Dick strips, wrappers, envelopes, etc., analysis by geographic and other pertinent classifications, preparation of expiration notices, preparation of publishers statements to the Audit Bureau of Circulations, etc. Large publishers who handle their own newsstand distribution also find punched card accounting particularly adapted to this branch of their business for use in order regulation, billing newsdealers, analysis and classification of returns, preparation of return credits, determination of overdue returns. Considerable cost savings are possible in this field but further details here would serve no purpose since in every case the development of an adequate system involves "tailoring" to suit the particular problems and organization involved. IBM, Remington Rand, Addressograph Multigraph Co., and most other large accounting machinery manufacturers have developed machinery and methods adapted particularly to the handling of the publisher's circulation fulfillment problems.

Special Auditing Problems and Techniques

The foregoing discussion of the balance sheet and income account of magazine publishers has indicated some of the special auditing problems encountered in the publishing field.

Some supplementary auditing techniques which have been found very helpful are outlined below:

1—Most publications which have newsstand subscriptions and advertising revenue are members of the Audit Bureau of Circulations or Controlled Circulation Audits, Inc., which for the purpose of determining circulation figures for use of advertisers make periodic audits of the publisher's records to determine the number of copies of a magazine which have been sold together with an analysis of the type of sale, etc. The number of copies sold as reflected in the ABC or CCA audit, together with the actual average revenue per copy of newsstand and subscription circulation determined by tests made by the independent auditor will be of substantial aid in forming a conclusion as to the correctness of the revenue figures reflected in the financial statements.

2—Publishers usually retain so-called "marked copies" or "pay copies" which reflect-on each advertisement in the magazine—the billing price of the space. Comparison of these copies of the magazine with billing records, rate cards issued by the publisher, and advertising lineage figures published in "Printer's Ink", will aid in determining the correctness of the advertising revenue.

3—Many publishers also indicate on the "marked copies" the cost of each piece of art and editorial work which appears therein. Accordingly, audit verification of the total costs of any issue is accomplished by comparing the individual costs with inventory or purchase records and totaling them.

4—Verification of paper costs is more involved and space permits only a general outline of the steps involved in one method which is often used.

Step 1:

Divide the size of the paper stock used by the size of the magazine page and multiply the result by two to determine the number of magazine pages printed from a sheet of paper stock.

Step 2:

Multiply the number of copies printed by the number of pages in the magazine to determine the total number of copy pages printed.

Step 3:

Divide the result of step 2 by the result of step 1 to determine the number of sheets, which amount divided by 500 will give the number of reams which should have been used.

The difference between the result of step three and the number of reams actually used in printing the particular issue of the magazine represents spoilage and waste—except so-called "trim" waste which was automatically eliminated in step one.

If the consumption of paper is available only in a figure representing weight, this amount must be converted into reams by dividing the weight used, by the weight per ream. For example—a ream of paper which is marked 24 x 36—72 means it is 24 inches by 36 inches in size and weighs 72 pounds per ream. Paper purchased in rolls must likewise be converted into reams by use of the so-called "basis weight".

It is customary to make the foregoing computations separately for paper used for printing insides and for cover and insert stock.

5—Usually, printing is done by independent printers and their charges must be verified with the printing contract which will usually include detailed schedules reflecting charges for composing, printing, binding, shipping and other operations. These contracts frequently include so-called "escalator clauses" which must be taken into consideration by the auditor in verifying the printers' bills.

6—Test-auditing is particularly satisfactory in the magazine publishing field because of the periodic nature of the publications. A careful detailed audit of the revenue, cost and expenses relating to one or more issues of each publication, and the development of appropriate cost and revenue statistics, will enable the auditor to form a sound judgment on the adequacy of revenue, cost and expenses of all issues of all publications as reflected in the annual financial statements. The following list of these statistics will be sufficient to indicate the principle involved. Incidentally, these statistics are very useful for general management purposes and are often included in the reports accompanying the financial statements:

Advertising pages per issue, analyzed by paid pages, trade advertising and house advertising and percentage of advertising pages to total pages.

Average advertising revenue per page.

Average advertising revenue per page per thousand copies.

Newsstand revenue per copy.

Subscription revenue per copy.

Editorial pages, the percentage of total pages and the cost per page.

Number of copies printed.

Paper cost per page per thousand copies.

Printing, engraving, composition costs individually per page (divided sometimes between editorial and advertising pages).

Shipping costs per copy.

Space does not permit a discussion and analysis of the various factors which will cause fluctuations in these indices or statistics but, needless to say, care must be exercised in their preparation and use to avoid errors and unwarranted conclusions.

Special Reports For Management

Planning the physical make-up of each issue of each publication is essential to successful publishing and cost figures analyzed in sufficient detail and supported by appropriate statistics will aid the publisher in determining the size of the magazine (i.e., number of pages), the size of the press runs (i.e., number of copies of an issue), etc.

Adequate cost analyses are also necessary in determining whether or not to commence or discontinue individual publications, vary the rate of publication, or delegate some particular function (such as research, subscription fulfillment or the like) to an outside agency.

Publishers usually require reports indicating the cost of, and results obtained from, subscription campaign ef-

forts analyzed by various mailings, type of lists used, type of promotion matter, etc., as well as daily or weekly statements of subscription expirations and renewals, and newsstand sales.

A special word should be said here about budgets which under present conditions are almost a necessity to all publishers. We have already discussed individual revenue and expense statements for each issue of each publication and related cost and revenue indices. These data, together with estimates of newsstand sales, subscription revenue and advertising space contracts in hand, form a very satisfactory basis for the preparation of sound budgets. As has been noted, this form of budgeting is more than a forecast of expected income and expenses since substantial control over future costs can be exercised by varying the number of pages; weight of paper stock used, size of the publications or press runs, etc. These budgets, together with an analysis of the reasons for significant variations in actual results of operations, should be reviewed as a regular part of every audit.

In preparing these special reports for management the accountant will encounter the question of whether or not to allocate indirect expenses and general overhead to individual publications. Practice in this respect is not uniform. However, if non-controllable indirect expenses, or general overhead items are allocated to individual publications or issues, the amount so allocated should be separately stated and clearly indicated to prevent any misunderstanding. This is particularly necessary because in the publishing field any method of allocating these items is likely to be arbitrary.

Taxation

Limitation of time and space do not permit an extended discussion in this paper of the special tax problems related to magazine publishing.

In the case of the Federal income tax, subscription income and circulation costs and expenses are accorded special treatment. For state franchise tax purposes, the location of plates, paper, etc., and income derived from out of state offices must be determined in connection with allocation formulas. Periodicals are exempt from New York City sales taxes and this is the case in most other jurisdictions. Paper and other components are generally exempt from the New York City Sales and Use taxes. For the purpose of the New York City business tax consideration must be given to allocation of advertising and other receipts. In the accounting records, wherever possible, the information relating to the above matters should be made as readily available as is practicable.

Conclusion

In conclusion it will be noted that the accountant is in a position to render valuable assistance to the magazine publisher. Editorial content is of course the keystone in the arch representing a successful magazine. But there are many other stones in that arch which may be labeled circulation, advertising, promotion, production, etc., and in making many of the management decisions which come under those headings, the publisher will lean heavily on his accountant who in turn must be prepared with sound accounting and cost records, carefully analyzed and intelligently interpreted.

General Principles of System Work

By Arthur B. Toan, Jr., C.P.A.

System work is related to the attempt to improve the way people carry out objectives efficiently and effectively by using proper clerical methods and routines. The general principles for doing system work fall into three categories—the principles involved in the clear and logical solution of any problem, the principles involved in handling the human aspects involved in any process of change and the principles involved in acquiring the specialized knowledge and experience essential to doing system work in the clerical field. Doing system work without giving adequate attention to each of these groups of principles is like trying to stand on a three-legged stool which has lost one leg—it can be done, and done successfully, but the odds are against it.

A discussion of the general principles of system work may be approached from many angles—the viewpoint of the system man, the viewpoint of the group of company employees whose procedures are being reviewed, or the viewpoint of management. In this discussion, we are going to consider principles of system work from the standpoint of the system man—from the standpoint of the man who is going to attempt to effect a change.

Let us imagine (1) that the management of your company has decided, for any one of a variety of reasons, to have a critical examination made of the accounting and clerical routines of your company, (2) that a firm of outside consultants have requested that com- in this survey, (3) that the outside consultants have requested that company representatives from various departments be assigned to that group, (4) that you are selected as the representative of the accounting department, and (5) that I am the representative of the consulting firm.

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This paper was presented by Mr. Toan on February 19, 1952, at the Bridgeport, Conn., chapter of the National Association of Cost Accountants.

Let us assume that the formalities and pleasantries of introduction have taken place and that, after several hours of guarded questions and answers, you finally feel we have reached a position where we can be frank with each other. You take a deep breath and say—"You know, I don't know why they selected me for this system group; I don't know anything about it; I don't know how you do the work, or even what you are trying to do. Are there any rules to follow? Are there any principles which serve as a guide?" I take an even deeper breath and say something like this.

There are principles of system work. They are fairly well-defined principles and they fall into fairly definite categories:

> Principles involved in the clear and logical solution of a problem—any problem

Principles for handling the human relations involved in any process of change

Principles for acquiring specialized knowledge and experience in the system field.

"System work" is a term which means all things to all people. I must confess that on varying occasions it has meant several very different things to me. The type of system work with which our system group will deal is concerned largely with getting people to carry out objectives efficiently and effectively by using proper clerical methods and routines. There are obviously several key words in that definition of system work:

People
Objectives
Clerical methods and routines.

Principles related to solving a problem

You will remember that I said a moment ago that there is one group of principles which relates to solving a problem—any problem. In many ways, this is the most important group of principles with which you will be concerned and certainly your chances of succeeding or failing will vary to an important extent to the degree to which you recognize and apply these principles. I know you will be glad to hear that most of these are good old common sense, nontechnical principles.

1—Determine the characteristics and nature of the events with which you are to deal. Do not confuse this with collecting the facts about the present routine. What you are really trying to do in system work is to determine an efficient and effective method of recording, classifying and summarizing the facts about certain events which transpire so that certain definite objectives will be reached. Having determined your facts and your objectives, you will be in a position to consider the best method of reaching your objective.

Let's, by way of illustration, consider what facts we might wish to know about factory supplies:

1. What are the principal classes and items
2. Where they are stored; under whose jurisdiction they are stored
3. Whether there are a small or large number of issues
4. Whether the stores issues represent an important part of manufacturing expense
5. Whether the individual stores are valuable, are apt to be stolen because they are easily removed from the plant, are useful, or are easily sold
6. Whether the replacement period is long or short
7. Whether many issues are for small amounts
8. Etc.

You will note that none of this information pertains to the present procedure and in fact no discussion of the present procedure is necessary to discover this information. The present method is one, and only one method, about which you will eventually wish to obtain information. To collect the facts about the events is rather different from determining the present method of handling the recording of these events.

2—Clearly define what information management, at its various levels, wishes to know about these events—the objectives of the routine, and make certain that these objectives are or have been established to be proper. While this probably sounds perfectly obvious to you, I dare say it is the principle which is most frequently overlooked or at least the one which is least successfully applied. You can do a lot of successful system work without carefully defining and establishing legitimate objectives but you will always be a tinkerer. You may do some pretty large scale and successful tinkering, but you will still be a tinkerer.

Let's take a cost system as an example. What are its objectives? According to one viewpoint, not heard quite as frequently any more, the objectives

of a cost system are reached when it is sufficiently accurate to produce inventory values. As an NACA member you know better than that—as a matter of fact you have had a lot to do with making accountants and management realize that a good cost system has a lot of other important objectives. For example, one of the most important objectives of a cost accounting system should be to develop information which will aid management in controlling expenditures by measuring the effectiveness with which manufacturing operations are being performed. It may very well be that an old-fashioned historical-cost type of cost system can be made to produce information about inventory costs more quickly and cheaply if you, for example, eliminate cents, handle small charges through overhead, etc.—but you will still be only tinkering. You may be tying up something with baling wire which should be discarded because you did not properly define your objectives.

If you don't want to be a tinkerer, you will have to learn to think in broad terms. You can't think in terms of limited objectives, of the objectives of a single small part of the organization, but rather you must think in terms of the organization as a whole. Why is that? Why aren't the objectives of an organization clear to all? There are several reasons:

In the large organizations of the present-day business world, the objectives of the entire organization are normally established by the management group. Sometimes they don't know or don't define the objectives of the organization as a whole; sometimes objectives are difficult to define because some of them are conflicting. But even if the management group is able to define the organization's objectives, the job is only started. Management has to parcel out the objectives or parts of the objectives among the various departments and administrative groups of the organization; it has to make sure that the various groups understand the objectives of the organization as a whole and exactly how what they are doing contributes towards those objectives; this is a task of great difficultv and is almost always imperfectly done. And lastly, and in some ways this is the most difficult of all, management must try to reverse old policies and old methods when old objectives are replaced by new.

What does this mean to you as a system man?

It means that you will, if you look hard enough and thoughtfully enough, probably find a number of procedures which are not properly directed at a good objective, are directed at an improper objective, or are directed at an objective which, while apparently good from the limited viewpoint of the immediate administrative unit concerned, is inconsistent with the valid objectives of the organization as a whole. The chances are greater that the true objective has either been missed or that the different groups do not understand the part each is to play—that either a gap remains or, more probably, that more than one group is carrying out the same part of the same objective—in other words, that there is duplication of effort.

It means that where several administrative groups on the same level of management are involved there are probably more problems of duplication than when the administrative units are on different levels of the organizational scale. This is due to the fact that department heads and others on the same level often prefer duplication to resolving conflicts by appealing to higher levels. This also means that you, as a member of the system group, will find that your ability to resolve conflicts of this type will be severely impaired if you permit yourself to become too closely identified with the interests of any particular departmental group. This is important and you should strive constantly to keep it in mind.

In short, make sure that you know the objectives and that they are correct

objectives from the standpoint of the organization as a whole.

3—With the facts about the events and the objectives before you, you will for the first time be in a position to consider the best way to get from events to objectives. In this stage of your work, remember to approach your work with an open mind and not to attempt to make up your mind too fast. List all the alternative methods you can think of, that you can obtain from others (other company employees, consultants, machine company representatives, other industrial companies with similar problems and any other sources of which you can think) and at that time list your present method as one of the alternatives. Obviously you will have to collect some facts about your present method in order to be able to do this; the important thing is to remember that the present method is just one of the alternatives (although presumably one of the better ones). The danger with obtaining too much information about the present system too soon is that it requires more mental discipline than you or I possess to continue to develop our list of possible alternatives after we become deeply enmeshed in the details of any one procedure. The chances are much too strong that you will become a tinkerer if you become too deeply involved in the details of the existing procedure. The time to tinker with the existing procedure is after it has been decided that it is the best approach—not before or instead of deciding.

4—Having collected the facts about the events, decided upon the legitimate objectives, and prepared a list of possible alternatives, you are in a position to eliminate alternatives until you arrive at the best method. What normally happens is that you are very quickly able to eliminate at least 75% of the alternatives and that, with little more difficulty, you have reduced your list to two or three. Then, obviously, by using the best experience and knowledge at your disposal, within yourself and your organization and outside your organization, you attempt to determine the best method. Frequently experimentation on a pilot plant basis is necessary. Don't make up your mind too quickly; don't take a position too quickly; do examine the alternatives cold-bloodedly and use every bit of advice and help that you can make available.

5—Develop your new method in detail only after it has been agreed upon in principle. Develop your proposal so that it will be clear to the employee with the lowest amount of skill and training who will have to read and understand it. Commit your procedure to writing and make certain that the procedure clearly indicates the administrative units which are responsible for carrying out the various parts of it.

6—Proceed with the installation only after the employees who are to carry it out have been fully instructed in both its method and its purpose. Make sure that someone is available during the actual installation period who is capable of making necessary changes quickly and correctly.

7—Never assume that the procedure you have prepared will, when put into effect, have the desired results; hope that it will, and do everything you can to make sure that it will, but don't assume that it will.

The only way to make sure is to check results after the new procedure has had a chance to operate for a few weeks or months. Obviously, you must be ready and anxious to accept suggestions from the employees who are operating the system or your check will be a failure.

8—Ascertain that proper consideration is being given to the new procedure in redistributing the work load among the employees. Many objections are made that claimed savings will not be realized because a clerk's entire time will not be eliminated and that he or she cannot be released. Supervisors who are unaware of their obligation to establish and maintain proper clerical work

loads should be followed up to determine that opportunities have not been missed to effect clerical savings by reassigning work among available employees so that wherever possible the full time of one clerk can be eliminated.

There are some other principles which I could, if I had a greater amount of time at my disposal, include under this grouping—but those about which I have already spoken are certainly the most important. Before going on to the next group, I'd like to restate them:

1. Determine the nature and characteristics of the events with which you are to deal. Do not confuse this with collecting the facts about the present routine.
2. Clearly define the information management wants to know about the events. Determine yourself or make certain that someone has determined that the objectives are proper.
3. After you have the facts and the objectives, list the possible alternatives for reaching the objectives.
4. Exhaust the list of alternatives until the best method has been determined.
5. Then, and only then, develop the detailed procedure.
6. Install the new procedure only after the employees who are to operate it have been fully instructed in both its method and its purpose. Be prepared to make on-the-spot revisions.
7. Check the actual results of the new procedure; don't assume it will work as planned.
8. Check to see that supervisors are taking the steps necessary to realize the savings, if any, which have been made possible by the new system by redistributing the clerical work load.

Principles for handling the human relations involved in a process of change

The second group of principles is concerned primarily with handling the human aspects of system work. I recently read an article in a national magazine which dealt with the labor difficulties encountered by a large company during the 1930's. It contained a short paragraph which read somewhat like this: "A brief diagnosis of the company's labor problems demonstrates two things: (1) managing a big corporation requires sociological savvy that has no relation to technical 'know-how'; (2) the management, which possessed the latter in abundance, had not enough of the former."

I would like to hazard the statement that managing a large corporation is not the only occupation that requires an appreciation of psychology and sociology—which is merely a fancy way of saying, of human relations. It is easy to shudder when you think of the quantity of potentially good system work which has failed in whole or in part because people were not properly handled.

Obviously, I haven't the slightest intion of trying to condense a Dale Carnegie book into a few words, but there are a few principles about human relations as applied to system work which I think you might find helpful.

1—It is dangerous for you to attribute resistance to change to inertia; the resistance to change which you will encounter in system work is normally more active and more deeply rooted than that would imply. Some of its causes are:

Fear of loss of job; fear of being shifted to another position carrying lower prestige; fear that deficiencies in the present procedure will be construed as criticism and lack of ability (with consequent bad effects upon future advancement); fear of the employee that, while he has learned and can operate under the present methods, the new methods will be beyond his capabilities without a longer training period than the company is prepared to undertake; fear that the investigation will rightly or wrongly indicate that the employee has been soldiering on the job, etc.

Besides fear, an important cause of resistance is dislike of the expert, the

"know it all" in any form, and the feeling that the expert's reputation will be enhanced to the extent that he can prove how much smarter he is than the others.

2—While resistance to change cannot be eliminated, it can be reduced by taking several steps:

Whenever possible, eliminate the worry of loss of job or prestige by announcing a policy of not discharging employees because of procedural changes but rather of transferring these employees to other jobs of equivalent standing, even if a period of retraining is required. After all, the employee is working for the company—not for a very small section of the company which may, for example, be concerned with processing invoices for payment. The employee rightly, it seems to me, can claim that he is entitled to a good deal of consideration so long as his work on his assigned job was satisfactory. In these days of large labor turnover, this certainly should be no problem.

Emphasize that you are trying to develop a method of working smarter not harder. If in the process of developing a method of working smarter, you also develop a method which results in working harder—all well and good—but any attempt to sell a procedure on the grounds of working harder starts out under a rather severe handicap because of its implication that past performance is poor.

Enlist the fullest practicable participation of employees affected by the procedure, emphasize their contributions and their importance and, while not minimizing your own, hold yourself in the background. Emphasize that this is a joint project and act that way. Get their ideas and suggestions, their concepts of the problems, accept their criticisms of your ideas in a spirit of equality. In short, get participation. Participation not only serves a legitimate and useful purpose in obtaining a solution of high quality, but also serves to eliminate many of the fears and dislikes I talked about a moment ago. It is an execellent device for educating both management and employees in the purposes and detailed workings of the new procedure. And, in case you are wondering whether your contribution will be overlooked, you might be surprised to hear that the less credit you try to claim, the more credit others seem to try to give to you.

To summarize the principles which fall under this heading you might say (1) don't forget the human aspects of systems work and, to sloganize, (2) remember that for big dividends in human relations, invest in the Golden Rule.

Principles for acquiring specialized knowledge and experience in the systems field

You probably have the impression up to this point that I haven't said anything about the kind of system work that you are going to do, that all the principles we have talked about so far pertain almost equally well to any problem involving people—that they might just as easily apply to a production line problem, to a selling problem or many others. If you have that impression you have exactly the impression I am trying to give. And, if you have that impression, you probably also have a question—what makes one system man better than another?

There are probably two answers to your question. Some people because of their nature, their training, their desire and their incentive are better able to solve problems than others—that's one of the reasons we have artists and accountants, engineers and salesmen, foremen and advertising managers. Some people like to work with people; others don't or can't. Some people seem to have minds which are more analytical or creative than others. That's one reason.

The other reason is that some people have acquired a technical knowledge of the problems and probable solutions in a particular field—in your case the field of system work. There are several

points at which this knowledge is most helpful—in distinguishing significant facts, in determining objectives, in determining possible methods for solving problems and in determining the relative desirability of each of the possible solutions. I don't know whether I am stretching the word "principles" too far, but I should like to consider that there are three principles involved in obtaining knowledge in the specialized field of system work in clerical routines.

1—The knowledge and experience you obtain in the following fields will probably be most helpful:

a. The way companies are organized and the methods for translating managerial objectives and policies into effective action.

b. The fundamentals of most of the important routines—payroll, billing, accounts receivable, etc.—which might be expected to apply, with variations, under many circumstances.

c. The most important principles of accounting and of internal control.

d. The characteristics, operating abilities, etc. of the more important office equipment, office gadgets, forms and office aids which are available.

This is a large order. And yet it is the problem. It is often the difference between seeing and missing the objectives, between listing and not listing all the alternatives and between selecting a better or an inferior solution to a problem.

Some of this knowledge you already have; you couldn't possibly have advanced to your present position without it. The remainder, you will have to get. If you are like most others, you will need a greater appreciation of management's problems and methods, their strengths and their weaknesses—and you will need a far greater knowledge of office equipment, gadgets, forms and other aids, than you now possess. Of them all, the most difficult to acquire and to maintain on anything approaching a current status is a knowledge of the availability and suitability of office equipment.

2—If you decide you want to get the knowledge and experience to become a good system man, concentrate on the basic fields of system work—budgets, costs, general accounting, production control, organization, etc.—before attempting to become an "expert" in a very limited field. You will find that you are able to see more clearly how a procedure fits into a business organization; you will find you are able more clearly to determine the proper objectives and that the list of alternative methods you are able to prepare will become longer and of higher quality.

I'm sure that the possibilities for obtaining this knowledge and experience are well known to you; they include books, pamphlets, discussions, visits to other companies, machine company schools and sales literature, research and experience within your own company, etc. Don't make the mistake of thinking that the newest is necessarily the best. The chances that 1952 will produce more valuable information than 1941-1951 are rather slim; but with the mass of information being written every day it is easy to lose yourself in reading and studying what is newest rather than what is best.

You can get your knowledge of specific fields when you have acquired the general knowledge of which I spoke, or when the specific problem arises, or you can rely on a systems consultant whose business it is to devote more time and effort than you are prepared or can afford to give to this type of effort.

3—When you study and when you try to store up your experience for further use, try to think of the basic underlying principles which are involved, and not of the example. An example is of little value without an understanding of the circumstances which surround it. If you get so that you think in terms of principles you can recognize the possibility of applying your knowledge in a larger number of circumstances.

Institutional Unit Costs

By Earle L. Washburn, C.P.A.

A discussion of unit costs in the light of the general objectives of institutional accounting.

To treat this controversial subject adequately would require far more time than is available here and this paper will therefore be confined to a review of some of the basic theory of *Unit Costs* and their place in institutional accounting. Much has been written and more doubtless will be, and in the end one will agree with Omar, the Tent Maker, that "Myself when young did eagerly frequent Doctor and Saint and heard great argument about it and about, but evermore came out by the same door as in I went."

Earle L. Washburn, C.P.A., is a member of our Society and of its Committee on Budgets and Budgetary Controls, and of its Committee on Publications. He is a former chairman of the Committee on Non-Profit Institutions Accounting of the Society. He is also a member of the American Institute of Accountants and of the American Accounting Association.

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Mr. Washburn is a Research Associate of the accounting firm of Chambellan, Berger and Welti, C.P.A.'s.

This paper was presented by Mr. Washburn at a technical meeting of the Society held on April 29, 1952, under the auspices of the Committee on Non-Profit Institutions Accounting.

Last year in a meeting similar to this one I expressed a dissenting opinion on the amortization of bond premiums. At the risk of being classified in accounting as the late Justice Holmes was in law, I am moved to voice virgorous objection to the development of unit costs, partly because of the burdensome expense involved in the calculations to determine such costs, and partly because of the doubtful value of the figures after they have been obtained.

Unit costs are tools of management designed to provide information with which the profitableness of any of the several products of a business may be determined. Any products which are found to be unprofitable may be abandoned and labor and material concentrated on those which are proved to be profitable.

Now, just where does this reasoning fit into the operation of a non-profit institution, the object of which is to render a service rather than to make a profit? The efficiency of an institution is not determined in terms of profit but in the quality of service to the community. A college cannot afford to abandon a part of its program merely because registration does not pay the cost of instruction. To do so would be to forfeit its standing; nor can a hospital abandon some essential service. The services capable of operating with a favorable balance may usually be counted upon to equalize those with a deficit.

In January, 1926, the Ronald Press published a volume for me entitled,

"Accounting for Universities", from which the following is quoted:

> "As the executors of an estate are accountable for its assets and the final disposition among the heirs, so the administration of a University is responsible for the proper care of such funds as come into its possession, and so long as the receipt and disbursement of all monies are effectively accounted for, nothing further can be asked or desired, since the fact of a profit or a loss is secondary consideration".
>
> "The keeping of the institutional accounts is part of administration expense and any system of accounts involving a considerable clerical staff beyond that actually required to perform the duties of the office should not be adopted, so that the largest sum possible of both gifts and normal income may be devoted to the service for which it exists."

A further vital consideration is whether it is possible to apply the principles of industrial efficiency to the operation of a charity which depends for its activities not alone upon the gifts, fees and other income which are available to it, but almost equally upon the devotion of those persons who engage in the charity as a life work, and whose compensation comes partly from the satisfaction of performing a service of benefit to humanity in general. Who can measure in dollars the services of a great teacher in the classroom, or the services of a great physician or surgeon in the field of medicine? My opinion has not been altered in the slightest degree in the twenty-five years since the book I wrote was placed in circulation, and it seems to me that the foregoing theory must be kept constantly in mind; otherwise we shall be misled as to the fundamental object of the account-keeping for eleemosynary enterprises.

On the other hand, as accountants we may be called upon to determine unit costs by some client who might not agree with the philosophy to which I have just given expression, and to that end a review of the history and methods of determining unit costs is of interest. One of the earliest publications on this subject appeared in 1919, and consisted of a circular by E. B. Stevens entitled, "How Much Does Higher Education Cost?" This was issued by the Office of Education in Washington. In 1925, the Macmillan Company published a volume entitled, "Unit Costs of Higher Education." This was reviewed and presented by the Education Finance Inquiry Association under the auspices of the American Council of Education. It was prepared for the Council by E. B. Stevens, at that time Executive Secretary of the University of Washington, and E. C. Elliot, at that time a member of the Commission. In my opinion, the contents of this volume have not been excelled by any publications in the field of college and university accounting released at a later date, though many meritorious volumes have been written. Some may be mentioned:

Morey, Lloyd, *University and College Accounting.* John Wiley & Sons, Inc., New York, 1930.

Hospital Accounting and Statistics. American Hospital Association, Chicago, 1940.

Roswell, Charles G., *Accounting, Statistics and Business Office Procedures for Hospitals.* United Hospital Fund of New York, 1946. Revised in 1950.

National Committee on Standard Reports for Institutions of Higher Education, *Financial Reports for Colleges and Universities.* The University of Chicago Press. Chicago, 1935. Now in revision.

Mills, Gail A., *Accounting Manual for Colleges.* Princeton University Press, 1937.

Scheps, Clarence, *Accounting for Colleges and Universities.* Louisiana State University Press, Baton Rouge, 1949.

Each of these contains all of the essential material to guide a practitioner in the development and application of statistical and financial infor-

mation necessary to determine the unit costs by whichever method may be chosen. An entire session of this Committee would be required to demonstrate visually these several methods. If there appears to be sufficient demand, a future meeting can be devoted to this feature of institutional accounting.

To what extent the determination of unit costs will improve the control of expenditures remains to be seen. Colleges and universities lean toward a system of financial cost projected through a budget which facilitates administrative control, thus avoiding the expense involved in the determination of unit costs. Voluntary hospitals, on the other hand, have gone to great lengths to determine the cost per patient per day in an effort to show the dollar value of free service. This information is claimed to be useful in obtaining gifts for support of the institution and in collecting allowances from municipalities and other agencies. The privately-endowed colleges and universities have explored the subject of Unit Costs on the basis of "full-time students", "the student credit hour", and "the student clock hour", but have been reluctant to adopt any of these plans, not because of the expense involved, but rather for other reasons some of which may be mentioned:

1. The tendency to use quantity rather than quality in evaluating the services of a program of instruction.
2. The tendency to compare the operating costs of institutions which are unlike without giving weight to such factors as size of enrollment, size of faculty, size of classes, teaching loads, salary schedules, and efficient use of physical plant and facilities.
3. Possibility of over-emphasis on the information from these costs for budget purposes.
4. Possibility of a department operating below average to use the information to fortify a request for larger appropriation than is actually needed.

Now, one may ask after this rather negative view, "Are there any advantages?" There are; and a few may be mentioned:

1. As an aid in internal administration.
2. In the determination of fees to be charged.
3. In preparation of the budget.
4. In surveys in connection with desirable reorganizations and adjustments within an institution.

Properly used unit cost figures can be very helpful and may in some cases justify the time and expense for their determination, but often a little knowledge is dangerous and the use of unit costs in an institution should be considered only after giving full weight to the major object—that of rendering a service.

Opinion is divided as to the future of unit cost determination. The growth of institutions of higher education, among others, has placed them in the field of big business. Because of dwindling gifts, resulting from heavy taxation of income and decreased earnings from endowments, "efficiency" may invade the campus and cause the productivity and drawing power of a faculty member to be determined. This is a far cry from the time-honored concept of the revered professor, beloved of students and alumni, or the friendly family physician with the bedside manner whose very presence created a sense of well-being. But the old order changeth and perhaps we had best be prepared to find out how much it costs to teach a student the art of tossing debits and credits about, or developing skill in the use of the slide rule, or translating a passage from Homer or Virgil, or the removal of a spare part from some suffering patient down to the last drop of anesthetic, the last inch of adhesive tape and bandage. Years ago no one thought much about tax accounting. But see where we are today. Casting aside my own feeling, perhaps we should prepare for what may be around the corner in the matter of unit costs.

The Revised Manual on College and University Business Administration

By Howard A. Withey, C.P.A.

This paper reviews the following topics in Volume I of the newly revised Manual on College and University Business Administration: principles of business administration, basic principles of accounting, basis of accounting, reporting requirements, budgeting, and auditing.

The topic assigned to me covers a subject which deserves considerably more time than can be taken at this particular meeting. Therefore, I have, of necessity, limited my presentation to some of the high spots of the new manual, leaving for subsequent meetings the presentation of detailed discussions of some of the principal points of interest to accountants.

The National Committee on the preparation of the Manual on College and University Business Administration wisely decided that Volume I should be devoted to the principles of business administration, basic principles of accounting, suggested forms for the presentation of financial data, budgeting and auditing. The second volume will be devoted to fields of administration other than financial, such as the operation of dormitories, dining halls, maintenance and operation of physical plant, etc. The first volume is now being published by the American Council on Education and should be available in the very near future. This volume is essentially a continuation of work of the National Committee on Standard Reports for Institutions of Higher Education, which was instrumental in the publication in 1935 of the volume "Financial Reports for Colleges and Universities," which is now out of print.

Howard A. Withey, C.P.A., has been a member of the Society since 1933. He is a partner of Franke, North, Hannon & Withey, C.P.A's., and is presently serving on the Committee on College and University Accounting of the American Institute of Accountants, which was formed to review the revised Manual on College and University Business Administration.

The material for this paper, which was presented at a technical meeting of the Society held on April 29, 1952, under the auspices of the Society's Committee on Non-Profit Institutions Accounting, was obtained from a draft of Volume I, College and University Business Administration, to be published by the American Council on Education in August, 1952.

All accountants, I am sure, will be interested in the opening paragraph of the chapter on basic principles of college and university accounting, which states as follows:

> "Accounting is a fundamental part of general administration. It is the means by which necessary data are made available to the controlling bodies and the executives responsible for efficient and faithful administration. The form and character of the financial data required should govern the development of the accounting system."

The importance of proper accounting for institutions of higher education was recognized by Trevor Arnett who stated, as far back as 1922, that

> "Common defects of academic financing and accounting may, therefore, be briefly summarized as follows: (1) the use of accounting systems unsuited to college needs, which fail to portray the actual

financial status of the institution and, (2) the absence of a budget system which tends to keep expenditures within the limits of income."

Basic Principles of Accounting

The primary requirements for financial accounting and reporting are stated in the following basic principles:

1. The accounts should be classified in balanced fund groups and this arrangement should be followed in the books of account and in the financial reports.

2. The financial transactions of the institution should be reported by fund groups.

3. The following fund groups are recommended:

   a. Current funds
   b. Loan funds
   c. Endowment and other non-expendable funds
   d. Annuity funds
   e. Plant funds
   f. Agency funds

4. The current funds group includes funds available for general operating and for current restricted purposes.

5. The loan funds group includes only funds which are loanable to students, faculty and staff.

6. The endowment and other non-expendable funds group includes only funds which are non-expendable at the time of reporting.

7. The annuity funds group includes funds acquired by an institution subject to annuity or living trust agreements.

8. The plant funds group includes funds designated or expended for the acquisition of additional property used for institutional purposes.

9. The agency funds group includes funds in the custody of the institution but not belonging to it.

10. If money is advanced or loaned temporarily from one fund to another, that fact should be set forth on the balance sheet by showing that amount as an asset by the fund group making the advance and as a liability by the fund group receiving the advance.

11. Receipt of cash or other property specifically designated to be added to the principal or balance of funds or to be expended only for physical plant additions should be accounted for separately from income expendable for current purposes.

12. The necessity for providing for renewals and replacements of property and of charging depreciation depends on the class of property under consideration.

13. The accounts should be kept on a modified accrual basis.

14. Current restricted income should be reported as income only to the extent expended during the year.

15. Current general income from endowment investments should be reported as income only to the extent distributed to the individual endowment income accounts.

16. Income and expenditures of auxiliary enterprises should be shown separately from other institutional operations.

The principles of accounting enumerated above were necessary, in the opinion of the Committee, to reflect properly the stewardship of the assets of the institution. I am sure that we all appreciate that educational institutions obtain a considerable amount of their income from private gifts, grants and appropriations on which limitations of various sorts are imposed in the expenditures of the monies. The observance of these principles will tend to insure the observance of the limitations. It might be in order to discuss briefly some of the basic principles and the means by which the observance of these principles will result in proper accounting for the stewardship of the funds.

Principles 1, 2, and 3 cover the requirement that funds of different types must be accounted for separately, and states the fund groups which are recommended. Principle 4 states simply that the current fund group should contain funds which are available for general operating purposes regardless of whether the funds may be restricted to some particular current purpose. This principle, together with principle number 14, recognizes that funds received for current restricted purposes should be included in income only to the extent of the expenditures covering the purposes of the particular funds. In other words, if a school should receive a gift to cover the president's salary for the next five years, the receipt would be classified as a current restricted fund. Transfers from this particular fund to income would be in the amount of the president's salary over the period covered by the gift to the extent of the expenditures for the president's salary. If the institution should be unfortunate enough not to have a president for any particular year, no transfer would be made from the principal of the fund to income. The same principle is involved with respect to income from endowments which are restricted to particular purposes. In the event expenditures are not incurred for the particular purpose for which the income is designated, the unexpended income balance remains as a current restricted fund until such income can be used for the purpose for which it is restricted. The accounting for restricted gifts or restricted income from endowment is diffcult to explain to a layman, and yet I believe the proper accounting for these items is of major importance to the institution. In many cases the assets of designated gifts or unexpended income from endowment is merged with other current assets of the institution; and in some of these instances, such assets have been used to finance current operations, even though the institution records an accountability for the unexpended balances of these restricted funds.

Accounting for Endowment and Other Non-expendable Funds

We all understand, I am sure, the necessity for proper accounting for endowment and other non-expendable funds. Many problems arise in the accounting by an institution for the income from the investments and the equitable distribution of such income in the event that the funds are pooled for investment purposes. The Committee recognizes and makes recommendations with respect to the accounting treatment for pooled funds, realized gains and losses on investments, additions to and transfers from the pooled funds and the accounting for funds held in trust by others for the benefit of the institution. Endowment fund accounting might well be made the subject of future meetings of the Society since the problem is too complex to be treated in general terms. However, the Committee has made several distinct recommendations regarding endowment fund accounting which might be enumerated:

1. Annuity funds or funds subject to living trust agreements should be classified separately as a fund group in the balance sheet of the institution rather than combined with endowment or other non-expendable funds, if the amount of such funds is material.

2. Assets of endowment funds or other non-expendable funds should not be merged with the investments of other fund groups.

3. Transfers of securities between fund groups should be recorded on the basis of the current market value as of the date of transfer.

4. Provision should be made for depreciation of real property held as investments of endowment funds and for the amortization of premiums paid on securities purchased.

5. The principles enumerated by the Committee recognize the possible necessity for establishing a reserve for the stabilization of endowment income, particularly in instances where the investments are pooled.

Proper accounting of the stewardship of the many different types of funds received by an educational institution presents one of the major problems to the accountants for the institution and perhaps is the least understood by many of the individual members of the governing boards. Many institutions carry in their accounts an account which might be termed a clearing account for gifts, from which account the various gifts are distributed to the proper fund group. This method of treatment has many advantages not the least of which is a source of information for reporting the amount of gifts to the Governing Board and to the public.

Classification of Gifts and Grants

At the risk of being repetitious, it might be well to treat briefly the various kinds of gifts and grants and the fund group in which such receipts should be classified:

First—The receipt of an amount, the principal of which is to be maintained and the income used for general institutional purposes would be classified under endowment and other expendable funds as general or unrestricted endowment. If the income from this prinicpal is designated for some particular purpose, the fund would be classified as a restricted endowment fund and the income from such fund credited to restricted current funds. As previously stated, this income should be included in the current operating income of the institution only to the extent expended during the reporting period. If the income from the fund is restricted for loans to students or for building purposes, the income would be transferred to the loan fund group or to the plant fund group.

Second — Receipts of substantial sums are oftentimes designated by the Governing Board to function as endowment as distinct from restrictions placed upon such funds by the donors. Upon such designation by the Governing Board the fund should be reflected in the endowment fund group as funds functioning as general endowment or funds functioning as restricted endowment depending upon whether the Governing Board has restricted the use of the income from the fund. The treatment of the income from these funds is generally similar to that of endowment funds.

Third—Gifts for current operating purposes are included in the current operating income of the institution if such gifts are unrestricted. In the event such gifts must be spent for a specific current operating purpose, the receipts should be classified under restricted current funds and included in current operating income to the extent of the expenditures in the reporting period.

Fourth—Gifts for buildings, equipment or other plant purposes should be classified in the plant fund section as unexpended plant funds. As these funds are expended, the unexpended plant fund balance is decreased and the amounts are reflected as additions to institutional plant by a contra-entry to the surplus account for funds invested in plant which is generally termed "Net Investment in Plant."

Fifth—Gifts to the institution which are to be used for loans to students or staff are accounted for as additions to the principal of loan funds.

Sixth—Grants for departmental or industrial research should be classified as restricted current funds and included in the income account in the amount of the expenditures for these particular projects during the reporting period.

Basis of Accounting

The Committee recognizes in principle 13 that the accounts of the institution should be kept on a modified accrual basis. By the term "modified accrual basis" is meant that the institution should record liabilities for materials received or services rendered and should reflect as receivables amounts due to the institution. The accounts are not maintained on a strict accrual basis since the institutions find it neither necessary nor desirable to report accrued interest receivable or to prorate certain expenses such as insurance premiums to future periods. These deviations from a strict accrual basis are particularly advantageous in the administration of the budgetary accounts.

The modified accrual basis and the surplus of general current funds are also a subject of misinterpretation and misunderstanding by layman and many members of governing boards. The general current funds of an institution might be termed the general operating accounts and the surplus of such funds, in the opinion of most authorities on the subject of college and university accounting, should be the amount which can be appropriated for future operations. On this basis the general current fund should, therefore, not contain items such as unexpired insurance, fixed assets having a short period of life, or other assets which cannot be realized in cash and used for future operations. In arriving at the amount of surplus which can be reappropriated, many institutions reserve from such surplus the amount of inventories, petty cash funds and other assets of a revolving nature, which are required for what might be termed working capital purposes. The provision for such reserves from surplus, in order to indicate the amount of surplus available for appropriation, oftentimes results in criticism of the institution based upon a misunderstanding of the principles behind such accounting treatment.

Reporting Requirements

A substantial part of the Manual is devoted to the financial reports of an institution, including the annual report to the governing body or to the public. A brief review of the reporting requirements may be of interest to this group and may be briefly summarized as follows:

1. The balance sheet of the institution is a concise statement of the financial condition of the institution and of the funds for which it is responsible. The recommended manner of presentation is to present the balance sheet in the form of separately balanced fund groups. In this manner the accountability with respect to each group of funds will be indicated.

2. The balance sheet will be followed by summary statements of changes in principal of the various funds or fund groups. The most natural sequence of presentation would be in the same order as the fund groups are presented in the balance sheet itself, which might be enumerated as follows:

   a. The balance or surplus of general current funds would be supported by a summary of changes in surplus and a summary of current income and expenditures.

   b. Current restricted funds would be supported by a summary statement of changes in balances of the individual current restricted funds.

   c. Loan funds would be supported by a statement of changes in balances of loan funds principal accounts.

   d. Endowment and other nonexpendable funds would be supported by a summary statement of changes in the principal of endowment funds.

   e. Annuity funds would likewise

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Allocation of University Endowment Fund Income

By Francis X. Fields, C.P.A.

This paper presents for consideration some factors in determining which of two generally accepted methods of allocating endowment fund income would be the more desirable in a specific case.

Income from endowment fund investments falls into two general classifications: restricted and unrestricted. Restricted income can be used only for certain designated purposes. Unrestricted income can be used for any legitimate purpose of the University. Were all endowment fund income unrestricted, all such income could be accumulated in one account. Where some of the income is restricted, however, it must be segregated from unrestricted income. Furthermore, it is necessary to allocate this income to the separate subsidiary accounts maintained for restricted endowment fund income.

No difficulties arise in the allocation of income from separately invested endowment funds. All income earned from the separate investments of each such fund is transferred to the income account of that fund. Income from pooled endowment fund investments, however, must be apportioned equitably on the basis of the respective interest of each fund participating in the consolidated pool. This apportionment generally is made either on the basis of principal account balances or on the basis of market values of endowment fund investments.

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This paper was presented by Mr. Fields at a technical meeting of the Society, held on April 29, 1952, in the Engineering Societies' Building, under the auspices of our Committee on Non-Profit Institutions Accounting.

Principal Account Balances (Book Value) Method

Under the *principal account balances method,* which I shall also call the *book value method,* pooled investment income is allocated on the basis of the relationship of the book value of each fund in the consolidated pool to the total book value of all funds in the consolidated pool. Careful examination of these income allocations discloses that certain inequities are inherent in the book value method. For example, new funds entering the pool generally are accepted at the current value of the assets they contribute. These new funds then participate in pooled investment income with the other consolidated funds on a book value basis even though the current value of the assets of the other consolidated funds (before the entry of the new fund) would normally be either greater or less than book value. Similarly, funds withdrawn from the pool either lose their participation in the accumulated undistributed gains or losses on sales of pooled investments or obtain their participation in them on the book value basis.

While admittedly there are these inequities in the book value method, the degree of error or the effect of the error may not be sufficiently important to warrant a change. For example,

since unrestricted income can be used for any legitimate purpose of the University, it could be expended for restricted purposes, and frequently it is so expended. If, therefore, an insufficient allocation of restricted income is made under the book value method, it might be considered to be offset by the required appropriation of sufficient unrestricted income to provide the funds for the necessary restricted purpose expenditures. Similarly, an excess allocation of restricted income could also be considered to be an appropriation of unrestricted income.

Aside from income allocations, participation in realized gains and losses on sales of investments becomes important only upon withdrawal of a fund from the consolidated pool, which is seldom. A number of universities do not prorate these realized gains and losses to the consolidated funds. They are left in an accumulated gain or loss account, probably on the theory that the main purpose of the consolidated investment pool is to provide strong assurance of stable income to the participating funds without gain or loss in principal. Under that theory, it follows that upon withdrawal a fund would not share in the realized gains and losses. In other instances, however, on the theory that participating funds should share ratably in realized gains and losses, funds being withdrawn are assigned a share of such gains and losses. The degree of error in computing these isolated allocations under the book value method would, of course, depend upon the circumstances.

Market Value Method

Under the *market value method,* investment income is allocated on the basis of the relationship of the participating values of each of the funds in the consolidated pool to the total participating values of all the funds in the consolidated pool. The participating values of the funds can be obtained by determining the total market value of the entire pooled investment portfolio, and prorating to the funds in the consolidated pool the difference between the total book value and the total market value. This proration is made on memorandum records or working papers, and is not entered on the books.

Participating values of all funds are readjusted periodically to reflect the changes in the market value of the pooled investments. Before a new fund is received into the pool, current participating values of the other funds in the pool are determined, and the new fund is admitted at the current value of the assets it contributes.

Investment income is considered to be more equitably apportioned on the market value basis because endowment funds received under varying economic conditions over a period of years are adjusted, for this purpose, to a common current basis. Realized gains or losses are also considered to be more equitably apportioned under the market value method. Upon withdrawal from the pool, a fund receives assets equivalent to the current participating value of the fund and any difference between this value and the book value of the fund is charged or credited to the accumulated realized gains or losses on pooled investments.

The major objection to the market value method is that the investment portfolio must be valued at market periodically. Difficulties and elements of error may arise in determining the market value of investments for which no market quotations are readily available and in evaluating real estate investments. Here again the degree of such error may not be sufficient to warrant a change or to warrant discarding consideration of the method. Another factor worthy of consideration is that participating values can be determined under an alternative mathematical computation in which these values once determined remain unchanged, the participating values of new funds being computed so as to

retain the proportionate market value relationship.

Conclusion

The major concluding observation on this subject is that either the book value method or the market value method is acceptable as a basis for the apportionment of investment income. Although the book value method is more widely used, the adoption and use of the alternative method would normally depend on whether a greater degree of accuracy in the circumstances is obtainable under the market value method and whether such greater accuracy warrants the additional effort and cost involved.

* * * * *

Note: For a comprehensive description of the market value method, see Harvey C. Daines' article entitled "Theory and Procedure for Pooled Investments in Colleges and Universities" in the February, 1940, issue of The Journal of Accountancy.

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be supported by a statement of changes in annuity fund balances.

f. Plant funds would be supported by summary statements of changes in unexpended plant fund balances, changes in balances of funds for the retirement of indebtedness and of changes in the net investment in plant.

g. Agency funds would be supported by a statement of changes in agency fund balances.

These statements of changes in fund balances would be supplemented by detailed statements to the extent desired.

Budgets

The chapter in the Manual on budgets should be of interest to the practising accountant since an understanding of the methods and procedures of budget making and administration will assist him in his study of the internal control of the institution. Proper administration of a good budget will provide the best method of control over expenditures of the institution.

Audits of Educational Institutions

The Manual contains a chapter on audits of educational institutions which was substantially written by the members of the Committee of the American Institute of Accountants which reviewed the Manual. By necessity, of course, the subject matter of this chapter had to be treated in general terms although I am sure that the practising accountant will obtain a considerable amount of information from this chapter, and it will be of assistance to him in planning the audit program. It is of interest to note that the Committee of College and University Business Officers which undertook the preparation of the Manual were insistent upon including the recommendation that an annual audit should be performed by independent public accountants. This statement is included despite the fact that many of the State institutions are audited by the State Comptroller's office or the State Audit Bureau as well as by auditors of the Federal Government with respect to many of the institutional expenditures.

The Terms "Surplus" and "Reserves" as Applied to Non-Profit Institutions

By Max Wasser, C.P.A.

The terms "surplus" and "reserves" continue to be misused by non-profit institutions. This paper suggests the use of more appropriate terms which have been recommended by the Committee on Accounting Procedure of the American Institute of Accountants.

The terms "surplus" and, more particularly, "reserves" are used in reports of non-profit institutions to convey a variety of different and often confusing meanings. There is a need to restrict the use of such terms, if not eliminate them in some cases, in order to make for a more readily understandable financial statement. The Committee on Accounting Procedure of the American Institute of Accountants, although not specifically mentioning non-profit institutions, has pointed out, in a number of Bulletins, the confusion resulting from the indiscriminate use of these terms and has made several remedial suggestions. It is my purpose to indicate how these terms have been misused in financial reports of non-profit institutions and to make recommendations to effect conformance with the Bulletins issued by the American Institute of Accountants.

Reserves

A reader of financial statements for non-profit institutions will often find the term "reserves" used a number of ways. First, he may find it used as a deduction from an asset for valuation purposes as, for example, "Reserve for Uncollectible Accounts" or where depreciation is recorded, a "Reserve for Depreciation." Secondly, he may find it used to indicate admitted liabilities of uncertain amounts as, for example, "Reserve for Damages", or "for Pending Litigation." Thirdly, he may find the term used to indicate the balance in a particular fund as, for example, "General Fund Reserve," "Special Fund Reserve", etc. Fourthly, he may find it used to indicate that an undivided portion of the assets has been appropriated for a special purpose such as a "Reserve for Contingencies," or for "Plant Expansion," etc. It is apparent that these various usages of the term "reserve" are inconsistent and hence confusing. In A. I. A. Bulletin #34 the Committee on Accounting Procedure recommends that the term "reserve" be limited to the last of the foregoing usages, namely, Reserve for Contingencies, etc. This most closely approximates what, in that committee's opinion, is the generally accepted meaning of the term. The committee suggests the substitution of more descriptive terms such as "Estimated Uncollectibles" instead of "Reserve for Bad Debts"; "Depreciation to Date" instead of "Reserve for Depreciation"; and "Estimated Liability for Damages" instead of "Reserve for Damages".

A further misuse of some reserves stems from the manner of their creation. Some institutions make use of reserves as a convenient method of converting a net operating income into

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His paper was presented at a technical meeting of the Society, held on April 29, 1952, under the auspices of the Society's Committee on Non-Profit Institutions Accounting.

a net operating deficit. This is accomplished by establishing the reserve by a direct charge to current operations. For example, the result of the operations of the XYZ Institution, for a particular period, might reflect a General Fund excess of income over expenditures of $30,000. However, the establishment of a Reserve for Contingencies in any amount over $30,000 by a charge to current expenditures would obviously result in a deficit.

To provide for contingencies by charges to current operating expenses, leads to inaccurate and misleading financial reports. The motives in creating such a reserve might be proper and valid, but all too often the authorities of institutions, having in mind their contributors, and fearful of the effect on them of showing an operating net income, resort to this device.

That this situation is not unique among non-profit institutions is clearly evident from Bulletins #28 and #35, issued by the Committee on Accounting Procedure. In Bulletin #28 it is pointed out that when reserves, as previously mentioned, are charged to current operations

> "*the integrity of financial statements is impaired and they tend to be misleading and of doubtful value.* The Committee is therefore of the opinion that general contingency reserves, such as those created:
>
> a—for general undetermined contingencies,
>
> b—for a wide variety of indefinite possible future losses,
>
> c—without any specific purpose reasonably related to the operations for the current period, or
>
> d—in amounts not determined on the basis of any reasonable estimates of cost or losses,
>
> are of such a nature that charges or credits relating to such reserves should not enter into the determination of net income." (Emphasis supplied)

In Bulletin #35 it was recommended that such reserves be created out of retained earnings. It was also the feeling of the Committee that in the financial statements, the charges for such reserves should appear in a separate surplus statement rather than in the income statement even though shown as a separate item after the amount designated as net income. It was believed that the latter presentation would possibly result in a misconception of the reader

> "as to whether the earnings for the period were the amounts captioned as net income or were the final and more prominent amounts shown on the income statements after the deduction of such charges."

To avoid any misunderstanding, the net income or loss from operations should first be transferred, in total, to the Statement of the Capital Account. Any additions to, or creations of, reserves would then be charged in such Statement of the Capital Account.

Surplus

The term "surplus", if indeed it ever appears in the accounts and statements of institutions, most often is used to denote a general fund excess of income over expenditures or a general fund excess of assets over liabilities. As this term generally connotes commercial profits its use should be avoided in institutions organized to render a service rather than to earn a profit. In fact, in Bulletin #35 it was the recommendation of the Subcommittee on Terminology that the use in accounting of the word "surplus" be discontinued entirely.

Instead of "General Fund Surplus", in this writer's opinion a more appropriate designation of the excess of assets over liabilities would be "General Fund Principal", or "General Fund Capital." In this connection, it is again pointed out that the terms "General Fund Reserve", "Special Fund Reserve", etc., are frequently used. However, as already mentioned, it is a misuse of the term "reserves."

Summary

1. The term "reserves" should be limited to only one usage, namely

(Continued on page 623)

A Report on the Cash Discount Fiction

By ARTHUR BLAKE, C.P.A.

Accounting theories and practices in respect of cash discounts are numerous and divergent. This article analyzes the theories and practices and reviews the pertinent literature for the purpose of clarifying the theory and determining appropriate accounting procedures.

A BUYER for a large retail business was examining a manufacturer's sample line and thoroughly enjoying the dispute over prices and terms. The salesman, however, finally exasperated, exclaimed, "You wouldn't take them if I gave them to you for nothing." "Of course I wouldn't take them for nothing," replied the buyer, "I'd lose my discount."

Another buyer in a different organization was asked to participate in a store-wide sale. After the sale he commented freely on having maintained his customary mark-up percent despite reduced selling prices, by means of special purchases skillfully arranged with his suppliers. Later it was learned that the special purchases had been on "terms: net cash" and that the reduced prices had been partly due to the loss of the store's usual eight percent discount.

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The Problem

It does not appear that a supplier offering a high rate of cash discount thereby offers his customers better value for their dollar outlay than they can obtain from a supplier offering a lower rate of discount. This viewpoint is reflected in the practice of reporting sales net of cash discounts as well as returns and allowances, on financial statements. However, it is quite generally contradicted by the practice of reporting purchase discounts as "Other Income", after "Net Operating Profit". Many companies treat purchase discounts as deductions from cost of goods sold, with favorable effects on their gross profit and net operating profit. These practices do not produce comparable results and published financial statements seldom reveal which practice is followed. Further variation is found in methods of determining the amounts of cash discounts to be reported in a given period. Many companies adjust for discounts included in merchandise inventories, accounts receivable, and accounts payable. Many do not.

It is evident, therefore, that cash discounts are treated as cost reductions by some companies and as revenue by others. Both cannot be correct procedures. Logically, according to the law of contradiction, cash discounts cannot have the quality of cost component and at the same time (as other income) not have it; or cannot have the quality of revenue and (as cost reduction) not have it.[1]

[1] Ewing, A. C., *The Fundamental Questions of Philosophy.* The Macmillan Company, 1951. Pg. 22.

General Treatment in Accounting Literature

The problems presented by these divergent practices are recognized and discussed in accounting literature. According to one authority, "The distinction between cost savings and actual, realized earnings is not always clearly drawn in accounting procedure. The outstanding example is the question of the treatment of purchase discounts."[2] Most writers of accounting texts describe four methods of reporting purchase discounts. They are:

1. Amount actually realized, reported as other income.
2. Discounts at the rate of two percent or less, reported as other income; discounts at higher rates deducted from cost of goods sold.
3. Amount actually realized, deducted from cost of goods sold.
4. Purchase invoices entered net of all discounts, cash and trade; lost discounts entered as expense.

The second and third methods are generally favored by those authors who expressed their opinions.

Other Income

The first method, by which all purchase discounts are reported as other income, seems to rest upon the following concept: Cash discounts are deductions allowed to customers to induce them to pay their bills within a definite time. This suggests that the discount is a fair price for the time by which the credit period is shortened. The fallacy of this concept is shown in several ways. First, the rate of return represented by the cash discount is beyond reasonable limits. Even a low rate of discount, such as 2/10 n/30, means that the supplier is paying two percent for twenty days anticipation of net settlement, an effective rate of thirty-six percent per annum. Money is not worth that much on a going concern basis. It thus appears that the cash discount is a penalty imposed against slow payment. Second, when planning a selling price, the required return to the supplier is considered covered by the net cash price and an amount representing the intended cash discount is then added. A supplier who needs for example, $92 to cover costs and a fair profit on a given item and who is led by trade custom to offer an 8% cash discount, must establish a loaded selling price of $100 which he neither needs nor generally expects to collect. He expects and will be satisfied with $92. From this it appears that the customer who takes the cash discount pays in full for the goods invoiced and merely avoids a penalty for delayed payment. Nor does it appear that a customer who fails to take the discount receives an asset of greater value as a consequence. Cost then ceases to be a measure of value.

There are other objections to this method. "As a general principle, profits are not made on purchases. A company cannot earn income merely by purchasing merchandise or fixed assets and taking the discounts, without making a sale."[3] In addition, taking all discounts is a requisite of efficient management. Hence it is not the discount taken which is significant but the discount lost.

Unfortunately, many textbook writers describe this method without discussion, in the early pages of their writings. Students of management and marketing who might benefit from clear concepts of the role of the cash discount, may therefore complete the study of basic accounting believing that it is good business practice to pay 2% for example, to accelerate cash collection by 20 days.

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[2] Paton, W. A., (Ed.), *Accountants Handbook*. The Ronald Press Company, 1949. Pg. 165.

[3] Finney, H. A., *Principles of Accounting, Intermediate*. (3rd Ed.), Prentice-Hall, Inc., 1946. Pg. 203.

Part Other Income, Part Cost Savings

The second method distinguishes between cash discounts which are cost savings and those which are revenue or other income. This is consistent with Income Tax Regulations which provide that merchandise purchases may be valued at "the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate,—".[4] Cash discounts which even at the low rate of 2/10 n/30 represent an effective annual rate of 36% do not approximate a fair interest rate. The "fair interest rate" test is relevant, not because of tax regulations, but because of its inherent logic in relation to the concept that cash discounts are offered to induce earlier cash settlement. Even 1/10 n/60 represents an effective rate of over 7% annually.

Those writers who report this method as an accepted business procedure, generally advocate treating discounts in excess of two percent as deductions from cost of goods sold, either separately stated or as trade discounts deducted directly from the invoices. There is general agreement on the reasoning. "Normally however, a purchase discount in excess of 2 percent, regardless of the net date, is viewed as a trade discount offered as an inducement to purchase or offered for large quantity purchases."[5] They do not deal with cash discounts included in merchandise inventories, accounts receivable, and accounts payable, on the balance sheet.

Cost Savings Entirely

The third method reports the amount of cash discounts actually realized upon the settlement of the liabilities and treats them as a reduction of the cost of goods sold. Accounting literature generally favors this method equally with the second method that treats only those discounts in excess of two percent as cost reductions. This method recognizes the nature of cash discounts as cost savings but has several material weaknesses. "The accounts do not show how much discount was lost by failure to pay bills within the discount period."[6] Moreover, the accounts and statements do not reflect professional skill unless periodic adjustments are made to convert the accounts from the cash basis to an accrual basis in respect of cash discounts. To do so necessitates an inventory valuation account, "Inventory Discounts Unearned", with a credit balance; and a valuation account for trade accounts payable, "Discounts Available on Accounts Payable", with a debit balance.[7] The "Purchase Discounts" account, on an accrual basis, then bears its true relationship to cost of goods sold. Leading firms of accountants have followed this practice for the past quarter century but it has not had full treatment in accounting literature. The chief weakness of this procedure is that it leaves cost of goods sold loaded with discounts lost, as though failing to take a discount could enhance the value of the goods so acquired.

Net of All Discounts

The fourth method provides for entering all invoices net of all discounts, based on the reasonable expectation that all discounts will be taken. Discounts lost by delay in settlement are then recorded as expenses consistent with principles of internal control. This procedure penetrates the "cash discount" fiction and views such cost savings as "trade discounts" by their nature. One technical authority states it clearly: "Such terms as 8/10 E.O.M.

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[4] Reg. 111, *Income Tax Regulations*. Sec. 29.22(c)-3. Par. (2).

[5] Holmes, A. W., and Meier, R. A., *Intermediate Accounting*. Richard D. Irwin, Inc., 1949. Pg. 98.

[6] Finney, H. A., *Principles of Accounting, Introductory*. Prentice-Hall, Inc., 1948. Pg. 381.

[7] Paton, *op. cit.* Pg. 886.

and 6/10/60 are really trade discounts. They are not allowed in order to induce payment, but are given because of existing trade practices. When a trade discount is allowed, the purchase is entered upon the books of account at the net price after the discount has been deducted."[8] An authority on auditing supports this. He writes, "—cash discounts on purchases are preferably considered reduction of invoice price or cost of sales—".[9] A leading accounting writer sums it up thus: "The theoretically sound method of treating purchase discounts is to show purchases net, and to treat the purchase discounts not taken as a financial expense.[10]

This method has the advantages of utmost simplicity, easily achieved uniformity, and theoretical soundness, as well as many advantages for control and management.

Technical and Practical Advantages

The advantages of entering all invoices net of cash discounts, in respect of merchandise purchases, are as follows:

Merchandise inventories: Cost net of cash discounts, or cash outlay, most closely measures the value of the merchandise for inventory purposes, except for unusual conditions. Values are not inflated by amounts representing collection incentives or trade customs capitalized.

Accounts payable: The liability is reported as the aggregate of actual payments to be made in terms of effect upon the asset cash. It is not inflated by an amount which the company, in the ordinary course of business, will not pay.

Gross profit: Percentages of gross profit in relation to net sales are consistent and comparable among similar businesses, among departments in a given business, and from year to year. Results are not affected by extraneous factors such as variations due to trade and local customs, discounts not taken, and special arrangements with suppliers.

Net operating profit: Percentages of net operating profits in relation to net sales are consistent and comparable, in respect of merchandise and discount transactions, among similar businesses and from year to year. Results are not affected by divergent practices of reporting cash discounts on a cash or accrual basis and giving effect to them, in whole or in part, as other income or as cost savings.

Management and control: Marketing and merchandise management are not complicated by varying rates of cash discount or no discount on materials handled. Adequate internal control is maintained over cash discounts lost. Bookkeeping is simplified by elimination of discount columns in books or original entry. Adjusting entries to accrue available discounts on accounts payable and to defer unearned discounts on merchandise inventories, are not needed.

Conclusion

The purpose of the cash discount offering is to control the time between receipt of the goods and settlement of the account and to differentiate between the treatment accorded the slow-pay customer and that enjoyed by the typical customer who pays promptly. The only lapse of time contemplated by the parties to the transaction is the period required to complete the procedures for receiving the goods physically and for writing the accounting records. This describes the usual situation.

Loss of the cash discount by the purchaser, is due to financial incapacity or inefficiency in most cases. The lost

[8] Tunick, S. B., and Saxe, E., *Fundamental Accounting—Theory and Practice.* Prentice-Hall, Inc., 1950. Pg. 7.

[9] Montgomery, R. H., Lenhart, N. J., and Jennings, A. R., *Auditing* (7th Ed.). The Ronald Press Company, 1949. Pg. 431.

[10] Holmes, *op. cit.* Pg. 98.

discount therefore, is a measure of the quality of financial or operational management. It should be given effect as such in financial statements. It is no part of the function of cash discounts taken or lost, to increase or diminish the effect of merchandise as a profit factor in the ordinary course of business.

The cash discount therefore, appears as an unnecessarily complicated and somewhat immature disguise for a penalty or pressure device. Costs of credit controls ought not be concealed in the costs of merchandise sold or on hand.

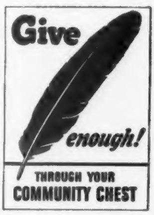
Business would do well to abolish the cash discount and to maintain its credit terms by requiring prompt payment as an essential part of satisfactory credit standing. Until this step is taken the same effect can be had by deducting cash discounts from purchase invoices before entry on the accounting records.

The Terms "Surplus" and "Reserves" as Applied to Non-Profit Institutions

(Continued from page 618)

as an appropriation of retained earnings for a special purpose.

2. Such reserves should be created by charges to the Capital account, rather than to current operations.
3. The charges for such reserves should be reflected on statements of the Capital account rather than on the Income Statement.
4. The use of the term "surplus" should be discontinued. The term "Principal" or "Capital" should be used to describe the credit balance of a fund (excess of its assets over liabilities).



As Others See Us

By Thomas W. Byrnes, C.P.A.

In a comparatively recent issue of a prominent magazine, there appeared an article containing information for young men and women about to graduate. A list purporting to include the fourteen major professions was shown in a two-page spread, setting forth in columns the requirements, the initial earnings, and the prospects, in each of the editorially selected fields of endeavor.

Practicing accountants were surprised and chagrined to note the omission of their vocation from the list, and in response to their requests a letter was sent from the office of the American Institute of Accountants to the editors of the magazine. A subsequent edition contained the letter without editorial comment. The failure to explain the omission can be construed, in this writer's opinion, to mean one thing only: that the editors do not consider Accounting one of the fourteen major professions, or possibly a profession at all; which leads to an attempt to ascertain the reasons for the editors' attitude.

Has the profession's effort to educate the public to the accountants' now-established place in the affairs of the world been too limited? By which is meant that the dissemination of information regarding the public practice of accounting has evidently not reached the eyes and ears of the editors. If so, the situation should be remedied at once, because it may be that magazine writers and editors are still thinking of the addition and subtraction phase of accounting as they heard it in their cloistered days. They may be laboring under the misapprehension that the public accountant is only a person adept with figures and they are unaware of the training the accounting student is obliged to undergo in matters pertaining to commercial law, finance, taxation, and all of the other branches of economics in which mathematical computations are employed merely for statistical purposes, and visual presentation. The journalists should be informed that the successful accounting practitioner of today must also be versed in history, literature, music, and the other arts, as well as conversant with past and current world happenings.

It is not the purpose of these lines to suggest procedures for the spread of enlightenment by national and state Accounting Societies' public relations staffs, but there is evidently still a job to be done.

As the foregoing was written there came the thought that the progress in national and international esteem achieved by public accountants in the past fifty years has possibly imbued some of its practitioners with a spirit of know-it-all which has offended other professionals; hence while deploring the attitude of others, it may not be amiss for accounting practitioners to indulge in a period of self-examination. *They may* be at fault.

In closing there are offered a few oft quoted lines from one of the immortal Burns' poems, and lest some editor facetiously call attention to the title of the poem, let it be understood that the lines apply to human beings in all walks of life:

"O wad the Power the giftie gie us
To see oursels as others see us!
It wad frae monie a blunder free us,
an'foolish notion."

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New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Some Income Tax Problems Resulting From the Death of a Partner

An individual partner is taxed upon his distributive share of the profits of a partnership regardless of whether he is otherwise on a cash or accrual basis. If the partner reports his income for a tax year that is different from that of the partnership, he reports each year his distributive share of the profits of the partnership for the tax year of the partnership that ends within or with the taxable year of the partner. If a partner dies, his taxable year for his final return ends on the day of his death.

Suppose a decedent, on a calendar year basis died on November 1, 1951, and that he was a partner in a firm reporting on a fiscal year basis ending June 30, 1951. On the final return of the decedent, income will be reported from the partnership for the period from July 1, 1950, to June 30, 1951. Will this return also include income from the partnership for the period from July 1, 1951, to November 1, 1951, since the partnership is dissolved because of the death of the partner? If the decedent is taxable on this income, more than twelve months income is being taxed to the decedent in one tax period.

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>
> Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is now serving as one of the Vice-Presidents of the Society and is also on the Society's Committee on Federal Taxation, and is past Chairman of its Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation and its Council.
>
> Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

The cases have dealt with this situation by drawing a distinction between the dissolution of a partnership and the termination of a partnership. If the death of a partner terminates the partnership under the partnership agreement and the state law, the final return of the decedent must include the distributive share of the profits to the date of death. If the partnership agreement provides that the death of a partner does not terminate the partnership but provides for its continuance for a period beyond the death, the partnership is dissolved but not terminated and the income of the decedent for the period from the beginning of the partnership fiscal year to the date of death will not be taxable to the decedent partner. It will all be taxed to the estate. The Uniform Partnership Act provides that the death of a partner dissolves the partnership but does not terminate it since it must be continued to wind up the partnership affairs.

Three federal circuit courts have held[1] that if a partnership agreement and state law provide that a partnership does not terminate on the death of a partner the final return of the deceased partner will not be taxed on the profits of the partnership for the period

[1] *Henderson,* CA(5), 155 F(2d) 310 (1946); *Girard Trust,* CA (3), 182 F(2d) 921 (1950); and *Mnookin,* CA (8), 184 F(2d) 89 (1950).

from the beginning of the partnership's fiscal year to the date of death of the partner.

A recent case[2] involved a partnership agreement that provided that the representatives of a deceased partner had the right to continue as partner or partners in the business in place of the deceased partner. The executor of a deceased partner tried to exercise this right, but the surviving partner refused to accept the executor as a partner. The dispute was settled by paying the executor for the decedent's partnership interest and his share of the profits.

The Tax Court held that the deceased partner's final return need not include the share of the partnership's profits up to the date of death, but the second circuit court reversed this decision. The court, in its opinion, assumed that dissolution was the same as termination on the facts of the case and did not attempt to distinguish this case from the *Henderson, Girard Trust,* and *Mnookin* cases, relying on the *Guaranty Trust* case,[3] where a dissolution of a partnership was deemed to be a termination.

It is not possible to say definitely just how the state would rule in a similar situation, but it is desirable to keep abreast of federal decisions affecting such cases. The discussion would be applicable to the effect of the state income tax law on partnership income.

Repair or Capital Expenditure

The acquisition of property or the permanent improvement of property is a capital expenditure not deductible as such. Depreciation based upon the useful life of the property may be deducted each year. If a repair is an ordinary and necessary expense it is fully deductible when paid or incurred. It is not always easy to draw the line between a repair and a capital expense and the issue is constantly litigated.

In a recent case[4] a tenant built a partition to make three offices instead of two. He treated the cost as a fully deductible expense. The Commissioner and the Tax Court held that the erection of the partition was an improvement to the building. The cost could be depreciated over the life of the partition or over the term of the lease if the latter term was shorter.

In our opinion the state law would follow this decision.

Constructive Receipt of Income

A cash basis taxpayer reports his income when he actually receives it in cash or its equivalent. To prevent a taxpayer from turning his back, as it were, on the receipt of income, both the federal and state laws through their regulations have adopted the principle of constructive receipt of income. It applies only to the cash basis taxpayer and in essence taxes him on income available to him without restriction though not reduced to cash.

For example, a taxpayer who receives a check as payment is in receipt of income on a cash basis. The check is the equivalent of cash. If the check is received on the last day of the year it is taxable for that year even though the check is not cashed until the following year. A recent Tax Court decision has held[5] that this principle applies even though the check was received after banking hours and therefore could not have been reduced to cash until the following year.

Any restriction on the collection of the check would take the realization of income out of the constructive receipt doctrine. Thus if a check is received on the last day of the year and the payee agrees not to deposit it until after the end of the year because of

[2] *Estate of Isidor Waldman,* U. S. Court of Appeals, 2nd Circuit, No. 64, April 14, 1952.
[3] *Guaranty Trust Co.,* 303 U.S. 493 (1938).
[4] *Halsam Products,* TC Memo, January 29, 1952.
[5] *Kahler,* 18 TC (No. 3), April 4, 1952.

a shortage of funds, the income would be taxable in the following year.[6]

In a recent case[7] a physician started an action in a patent infringement case. The defendants settled the case. One of them made the payments for damages in installments. The last check was mailed from Ohio on December 30, 1943, to the doctor's attorney in Florida. The doctor actually received the check in 1944 and reported it as income for 1944. Later he filed an amended return and included it as income for 1943. It was to his advantage to do so in order to come within the provisions of Sec. 107(b) under the Federal Code. (There is no similar provision under the state law). The court held that the check was constructively received in 1943. The parties had agreed that payment would be made in 1943 and more important the money was available in 1943.

The argument of the Court would be equally applicable to the determination of what constitutes constructive receipt.

Inventories

If inventories are a factor in the production of income a taxpayer must report income from a business on the accrual basis. The basic problem is the valuation of the inventory. Both the federal and State income tax laws prescribe regulations for the valuation of inventories. Accountants, of course, are familiar with the principle that inventories may be valued at cost or cost or market, whichever is lower. To reflect income clearly the taxpayer must be consistent in his method from year to year. A change from one basis to another requires the consent of the Tax Commission and the commissioner.

Unless properly restrained by their accountants taxpayers tend to write down the value of the closing inventory in order to keep profits lower. They will try to justify write-downs to their accountants on the basis of what they believe to be sound business judgment. Arbitrary write-downs are not accepted for tax purposes. Sec. 29.22(c)(2) of the I.R.C. and Art. 217 of the Regulations under the state income tax law provide that "any goods . . . unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, change of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, where basis (a) (cost) or (b) (cost or market, whichever is the lower) is used . . . ." If these provisions are the basis for write-downs, the taxpayer must be able to substantiate the values used.

In a recent case[8] the taxpayer valued its closing inventory by arbitrarily writing down the merchandise to one-half the cost. No evidence was submitted of market values, which are defined in the regulations as "the current bid price prevailing at the date of the inventory for the particular mechandise in the volume in which usually purchased by the taxpayer." The Commissioner substantially increased the valuation by deducting the average mark-up from the retail price to determine the value of the inventory. The court sustained this valuation saying also that the average mark-up made an allowance for broken lots, damaged or defective merchandise.

A taxpayer who arbitrarily writes down the value of his closing inventory usually is short-sighted and really outsmarts himself. By writing down the closing inventory he increases the income of the subsequent period when such items are sold. In a period of rising prices and higher tax rates such income may be subjected to a greater tax than if the inventory had been correctly priced in the first instance. In

[6] *Fischer,* 14 TC 792 (1950).
[7] *Mc Euen,* CA (5), April 10, 1952.
[8] *Ashe, Inc.* (T. C. Memo February 29, 1952).

addition to this, the income for both periods is distorted to the discomfiture of the accountant who is presented with the problem of certifying a statement in accordance with good accounting principles.

Deductions for Flood and Fire Damages—(Casualty Losses)

In the April 21st issue of What's Happening in Taxation,[9] Prentice-Hall devotes almost two columns to a discussion of some of the tax aspects of the damages resulting from the disastrous floods last spring in the midwest. Under Sec. 23(e)(9) I.R.C. and Sec. 360 of the State Law, losses resulting from the floods are fully deductible from gross income. Any insurance or other recovery such as Red Cross aid, reduces the loss.

If business property is entirely destroyed the deduction is the adjusted basis of the property at the time of the loss, less any salvage. On a partial loss of business property the adjusted basis is multiplied by a fraction. The numerator is the difference between the value of the property before and after the casualty, the denominator is the value of the property before the casualty.

On non-business property the deductible casualty loss is the difference between the value of the property before and after the casualty. This may not exceed the adjusted basis of the property less any insurance recovery. The article points out that on a partial destruction the cost of repairs may be a realistic measure of the loss. This was allowed in one case[10] where the taxpayer substantiated the cost of necessary repairs, and showed that the repairs were confined to the damaged parts; the amounts paid were not excessive and the repairs did not increase the value of the property.

It should be noted that under the Revenue Act of 1951 a casualty loss is treated as a loss sustained in a trade or business and so treated as an operating loss carry-back and carry-forward. Our state law, of course, does not have any similar provision.

The time for taking the loss is a problem particularly where any insurance recovery is involved. If the insurance is recovered in the year of the casualty loss, the recovery reduces the loss in the same year. If the amount of recovery is reasonably fixed in the year of the loss, but the insurance is actually received in a later year, the insurance recovery must still be considered as a reduction of the loss.

A deduction may be postponed to the year of a final determination if the insurance claim for the recovery is questioned, but there is some prospect of recovery in a reasonable time. It was so held in *Commissioner* v. *Harwich*.[11]

If there is no prospect of recovery the full loss is deductible in the year of the casualty. Any insurance recovery in a later year would then be income for that year to the extent that there was a tax benefit in the year of the loss.[12]

If the insurance proceeds exceed the adjusted basis there is a taxable gain. Under Sec. 117(j) this would be a capital gain under the federal law but *not* under our state law which has no similar provision. Under the involuntary conversion provisions of both laws the gain may be avoided by reinvesting the insurance proceeds in similar property or establishing a replacement fund.

Non-taxable Exchanges—Trade-in of Property

A completed transaction is a taxable event and an exchange of property as well as a sale is usually a completed transaction. The exceptions to the rule that exchanges are completed taxable transactions are enumerated in the law.

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9 Volume 14, Number 46, published by Prentice-Hall, Inc.
10 *Harmon*, 13 T.C. 373 (1949).
11 184 F(2d) 835 (1950).
12 *Cahn*. 92 F(2d) 674 (1937); *Dobsin*, 320 U.S. 489 (1943).

(Tax Law, Sec. 354.) One of the exceptions is an exchange of business property for property of like kind. It is important to remember this exception because of the common practice of trading in an auto in purchasing a new car. If the trade-in results in a loss on the old car, the loss is not deductible because the exchange for a new car plus cash comes within the exception to the rule that an exchange of property is a completed taxable transaction. If the trade-in allowance results in a gain, the gain, of course, is not taxable.

To establish a loss the old car should be sold, thus avoiding the non-taxable exchange. A gain on the exchange works to the advantage of the taxpayer. The unrecognized gain or loss is included in the basis of the new car in computing subsequent depreciation or gain or loss on the new car.

Estate Tax—Interest on U. S. Savings Bonds Series G

Series G Bonds are current income savings bonds with interest payable semi-annually from the date of issue on the face amount. If bonds are redeemed prior to maturity, interest ceases on the last day of the interest period preceding the date of redemption. Upon the death of the owner the bonds are redeemable upon receipt of notice to redeem at par.

In a recent case[13] a decedent owned Series G bonds in the amount of $325,000. He died on October 14, 1946. The executor redeemed $25,000 worth of bonds at par without the payment of any interest. The interest collected by the estate on the remaining bonds was reported on the fiduciary tax return, but no interest was included in the gross estate from the last interest payment to the date of death. The Commissioner held that such interest had accrued at the date of death and that the right to the interest represented property of the decedent includible in the gross estate (Sec. 811(a) I.R.C.). The corresponding state provision is Sec. 249-r of the Tax Law. The executor argued that at the date of death there was no obligation on the part of the Treasury Department to pay any accrued interest from the last payment date since the bonds might be redeemed at par without interest.

The court held that the accrued interest did not constitute property which was transferable from the dead to the living. No interest from the last payment date attached or accrued before the expiration of the full six months' period. This was emphasized by the fact that $25,000 of bonds were actually redeemed at par without the accrual of any interest. The bonds had to be held until the next interest payment date for a right ever to come into existence. Hence, accrued interest on G bonds is not includible in the gross estate for estate tax purposes. The state law would be similar and such accrued interest would not be subject to the New York estate tax.

Thinly Capitalized Corporations

Traditionally, corporations have financed themselves through the issuance of stock (equity capital) or bonds (borrowed capital). Taxwise the difference is important, since the interest paid on borrowed capital is deductible from gross income whereas dividends paid on equity capital are not. The impact of high tax rates has led taxpayers to emphasize the borrowed capital aspect of financing rather than the equity capital. To meet this avenue of tax avoidance the Commissioner has been arguing that where the debt structure in relation to stockholder's equity is top heavy, the indebtedness is not a true indebtedness but is in substance the stockholders' equity. This is particularly true where the stockholders and bondholders are virtually the same. The interest is therefore deemed to be a

[13] *Estate of Willis L. King, Jr.* v. *Commissioner*, 18 T.C., No. 50, May 28, 1952.

dividend and is disallowed as a deduction.

In a recent Tax Court case[14] a real estate corporation had outstanding stock of $600,000 and a bonded indebtedness of $2,100,000. The bonds carried interest at 6% and matured in eighty years. This exceptionally long-term maturity probably led the Commissioner to his determination that the bonds in substance represented equity capital. The ratio of the indebtedness to the equity was 3½ to 1 but the Tax Court held that the equity capital was substantial, the corporation was not thinly capitalized, the bond issue was just what it purported to be, a true debt, and the interest was allowed as a deduction.

One aspect of this situation has been solved by the state in the case of real estate corporations. Sec. 182 of the Tax Law places a 2% tax on ninety per cent of the interest paid on indebtedness owed directly or indirectly to any stockholder, or members of his immediate family, owning in excess of five per cent of the issued stock, the proceeds of which indebtedness are used to acquire assets. However there is no such tax on interest not exceeding $1,000. In the case of business corporations under Art. 9A the law limits the deduction for interest paid to stockholders owning more than 5% of the issued capital stock of a corporation. 90% of such interest paid, or all such interest less $1,000, whichever is less, must be added back for New York State tax purposes (Sec. 208 Tax Law).

[14] *Ruspyn Corp.*, 18 T.C., No. 93, July 22, 1952.

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

A development worthy of note has occurred in recent months in connection with earnings summaries and financial statements included in prospectuses filed with the SEC under the Securities Act of 1933. Companies filing under this Act have received fairly uniform comments from the SEC, the following comment being typical:

> In connection with the income statement for the six month period ended June 30, 1952, included under "Earnings Summary" and in the financial statements, it is requested that this Division be furnished as supplemental information, not as an amendment to the registration statement, a letter describing in detail the nature and amount of adjustments other than normal recurring accruals, entering into the determination of the results reported. In addition, a representation should be made in a footnote to the summary that all adjustments necessary for a fair statement of results for the six month period have been included.

In another case, a company received the following comment from the SEC:

> A representation should be made in a footnote to the summary that all adjustments necessary to a fair statement of the results for the unaudited interim period have been included. In addition, it is requested that this Division be furnished as supplemental information but not as an amendment to the registration statement a letter describing the nature and amount of any adjustments, other than normal recurring accruals, entering into the determination of the results reported for the unaudited period.

So many companies filing under the Securities Act of 1933 have received the same or similar comments from the SEC with respect to unaudited interim figures included in the summary of earnings or in financial statements, that the Commission's comments seem to be of a pattern.

We understand, however, that the SEC has not been making similar comments with respect to interim figures which are certified by independent public accountants. Manifestly, it would be unreasonable to insist that companies make a representation to the effect that all adjustments necessary for a fair statement of the results for the interim period have been included when an accountant's certificate covering that period says, in effect, substantially the same thing.

It is possible that this development in SEC practice stems from the decision in the *Kaiser-Frazer* case, which appeared in our previous issue.

Many companies which issue press releases covering interim figures frequently say that the figures are subject to year-end adjustment. Some of the accounting people in the Corporation Finance Division of the SEC are of the opinion that the phrase "subject to year-end adjustment" is unnecessary in a prospectus and should not be used where the figures are stated to be unaudited. We have recently observed, however, a prospectus in which it was stated that the figures for the interim period are "subject to possible year-end audit adjustments; however, all adjustments necessary for a fair statement of the results for the period have been made."

Louis H. Rappaport, C.P.A., has been a member of the Society since 1933. He is a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A's.

Notes on the New York State Unemployment Insurance Law

Conducted by SAMUEL S. RESS

Some Proposed Amendments

1. Section 575, subd. 4—Ten Dollar Penalty Assessments

Under the present law, an employer who fails to reply to a "Request for Employment and Wage Data" within *seven* days after the date that the request was mailed to the employer by the Industrial Commissioner, is subject to a $10 penalty assessment with respect to each individual employee for whom such request was made. Section 575, subsection 4, reads as follows:

> "4. Request reporting requirements. Every employer shall report on request of the commissioner, within seven days of the mailing or personal delivery of such request, employment information with respect to an individual employee and the remuneration which he paid to such employee. If any employer fails to comply with the provisions of this subdivision, he shall pay a penalty in the amount of ten dollars with respect to each request with which he did not comply, unless he shows to the commissioner's satisfaction that such failure to comply was due to circumstances beyond his control."

It is suggested that this provision of the law be amended to read:

> "4. Request reporting requirements. Every employer shall report on request of the commissioner, within *ten* days of the mailing or seven days of the personal delivery of such request, employment information with respect to an individual employee and the remuneration which he paid to such employee.
>
> *"If any employer fails to comply with the provisions of this subdivision within twenty days after the mailing or personal delivery of a demand of the commissioner for such report, he shall be subject to a penalty in the amount of three dollars with respect to each employee for whom he wilfully refuses or fails ot file such report. No penalty may be assessed where such failure to comply was due to circumstances beyond the employer's direct control."*

This section of the law should be amended because it has created much hardship and because of the inflexible and highly punitive provisions contained in it at the present time. Penalties running into hundreds of dollars have been assessed against a large number of employers where a bookkeeper was away on a two-week vacation during which period these requests remained unanswered until she got back on the job. In other cases where the nature of the business does not require a steady bookkeeper and the work is done by the accountant on a write-up basis once or twice a month, inquiries from the Division of Placement and Unemployment Insurance regarding a former employee may not receive the attention of the accountant until after the present seven-day period has elapsed. The present request requires the employer to check back and report on the remuneration for a fifty-three week period immediately prior to separation day of each former employee for whom he receives a request. The preparation of that report is time-consuming and when large numbers of such requests are received the smaller

SAMUEL S. RESS has been an Associate Member of our Society since 1936, and is also a member of the Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is a member of the Society's Committees on Clothing Manufacturing Accounting, on Labor and Management, and on State Taxation.

firm that employs one or no bookkeeper or an accountant on a write-up basis only, finds it most difficult to report back accurately within the seven-day period. Some firms do not prepare their payrolls until a week or ten days after the week in which the worker was employed. In the ordinary course of events they are not able to give the Industrial Commissioner the information he requests because they have not set up on their records the remuneration of their employees for the last week worked before the present seven-day period has expired, with the consequent $10 penalty being imposed for each default.

Where the employer delays responding to the request of the Industrial Commissioner merely for the purpose of delaying the processing of a former employee's benefit claim, upon a proper showing that such was the fact he should be summoned to appear before a Referee who should be empowered to impose a proper penalty or fine for such action.

2. Voluntary Unemployment Insurance Contributions To Secure More Favorable Rates

The present New York State Unemployment Insurance Law contains no provision for voluntary contributions in addition to required contributions for the purpose of obtaining a lower tax rate during the ensuing year. The laws of 19 states and territories contain some provision for voluntary contributions for the purpose of obtaining reduced rates. Some relief should be given to employers who find themselves saddled with a 2.7 per cent rate for a three-year period merely because of a single bad year which may have resulted in a small negative balance in their unemployment insurance account.

The voluntary payment of a few dollars in additional contributions may result in the reduction of the tax rate on a payroll of many thousands of dollars a year.

Some provision could be included to allow for a refund of any voluntary contribution if it should fail to effect a contribution rate reduction.

Accountants and the Wage and Hour Law

In his column on "Office and Staff Management" in the September, 1952, issue of *The New York Certified Public Accountant,* Max Block pointed out that Wage and Hour Examiners of the United States Labor Department are checking accounting firms' payrolls for failure to observe the law's requirements with regard to errors in calculating overtime pay. At his request, this paragraph has been prepared to help guide accountants in determining the regular rate of pay.

A non-exempt employee who works more than 40 hours in any week must be paid for the hours over 40 at a rate not less than time and one-half the regular rate of pay at which he is employed. The regular rate of pay is a rate per hour. All remuneration for employment must be included except:

1. Bona fide gifts made on special occasions
2. Discretionary bonuses
3. Payments from profit-sharing or thrift plans
4. Pay for unworked time
5. Traveling and other non-wage payments
6. Contributions paid to pension and health plans
7. Daily or weekly overtime
8. Premiums for work on Saturdays, Sundays, holidays, regular day of rest or sixth or seventh days
9. Premiums for work outside the regular workday or workweek

Daily or weekly overtime and the premium payments indicated in items 8 and 9, above, can be offset against overtime due under the law.

Where there is a variable workweek whereby the employee works no regular number of hours a week but receives a

steady salary for his work, the regular rate of pay is figured by dividing each employee's weekly salary by the number of hours worked that week. This gives the employee's rate of pay for that week. Take half of that rate and multiply it by the number of hours worked in excess of 40 for that workweek. The total is the amount of extra overtime pay that the employee must be paid in addition to his regular steady salary.

An employer can cut overtime expenses for employees who work irregular hours by using the irregular workweek plan of computing overtime. The employer has to pay only the extra half-time for all hours worked over 40 instead of an extra time and one-half that he would have to pay if he based his overtime on a fixed number of hours a week.

To use the irregular workweek plan it is essential that the employee understands that his salary is his straight time pay for all hours worked in a week no matter what the exact number of hours may be, and that the irregular hours are irregular in fact. A carefully worded written agreement signed by the employee would be very helpful in establishing an irregular workweek plan.

AN ADIRONDACK VIEW

Survey of a State. For some time we have wanted to count the noses of CPA's, other public accountants, and other professions located in a large area. Somehow or other our own large area seemed to have too many pines and hemlocks—and also is only a small part of a state.

Now patience is rewarded! We have a whole state under our scope. A whole state in one telephone directory. And here are the counts:

Lawyers—listed as "Attorneys" no less (up here in the woods they are listed as just plain "Lawyers.")—total 135; no big black type or ads.

Physicians—96, with three listed in big type.

Architects—18 with five in bold-face type.

Public Accountants—30, of whom two had boxed ads and twelve had bold-face type.

Bookkeeping Service—6, with three using bold-face type and all being also listed as Public Accountants. We never could see why bookkeeping service was anything but a good sensible business service—why try to soup it up into anything else.

Certified Public Accountants—4 offices, 8 different individuals, no boxed ads, and no big black type. Hats off! Now look in the Gotham Classified Directory—and Buffalo, too—also Nassau County—and New Rochelle et al.—and Yonkers—oh! oh! black marks for big black type!

And that's that—more lawyers than any other profession—and CPA's the least of all.

Well, I can't help it if the only directory I could get my hands on that covered all of one state was the State of Nevada. Thank you, Nevada—and congratulations on having the highest income per capita ($2,029) in 1951.

By Leonard Houghton, CPA
of the "Adirondack Chapter"

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Administration Now a College Subject

The City College of New York has added to its accounting curriculum a course in "Accountancy Practice." It will cover the entire field of independent practice and will include such subjects as: developing a clientele, partnership arrangements, office organization, staff direction, and other phases of a practice. The course is on the graduate level and the enrollment was completed on the first day of registration.

For the class textbook, Paul Bacas' "The Successful Practice of Accountancy" will be used.

If this course proves to fill a need, as presently appears quite likely, provision will undoubtedly be made to take care of larger enrollments. Readers of this column may be interested to know that its Editor is one of two lecturers giving this course.

Accountants' Wage Hour Problems

In last month's column readers were cautioned about correct compliance with the Wage Hour Law. Mention was made of the fact that the determination of the basic hourly rate, on which the overtime premium is based, must be computed on the basis of the prescribed work week as actually demonstrable by the records and employment understandings.

Another factor that may affect the basic rate is annual bonuses. Where the payments are, as a reality, part of the annual compensation, they add to the hourly rate. However, where bonuses are strictly voluntary payments and are not held out as part of the annual compensation, they may not be held to affect the basic hourly rate.

In Dr. Ress' column, "Notes on the New York State Unemployment Insurance Law", there is a more detailed discussion of this subject. Therein are listed other compensation factors which do not affect the basic pay rate for overtime rate purposes.

MAX BLOCK, C.P.A. (N. Y., Pa.) is a Director of the New York State Society of Certified Public Accountants and has been the Chairman of the Society's Committee on Administration of Accountants' Practice. He is a member of the firm of Anchin, Block & Anchin.

Keeping Staff Members Interested

Everyone loves a change, and normal people crave some recognition. This applies to accounting staff members no differently than to anyone else. One way to accomplish this, with possible benefit to the client, the individual accountant, and to the firm, is the assignment of special studies of practical problems.

For example, where a client complains about the office being chronically behind, an analysis of the conditions responsible therefor may be assigned to the senior on the job. Where it is known that a system can be improved, or internal control tightened up, these might be opportunities for projects.

The improvement of a client's report form might be a project. Any number of such opportunities exist and they can be used to challenge a man's analytical powers and judgment.

Subjects of broader interest, such as an aspect of audit procedures, report preparation, tax department mechanics, and other subjects of a general nature also lend themselves to assignment for consideration and a report of recommendations.

While these projects may not be initiated with the idea of building up fees in any particular instance, there is a likelihood that an extraordinary accomplishment benefitting a client may nevertheless develop into such a benefit.

Tax Department Record of "Loss" Years

When new income tax provisions are enacted, accountants are occasionally obliged to ascertain the clients who had filed "loss" tax returns and the years involved. This develops from retroactive provisions which may benefit such clients. Obviously there are other reasons why "loss" records are needed, particularly for "loss carry-back" purposes.

A dual record is involved, one by years and another in terms of clients' names. Each is useful under different conditions.

Readers are requested to submit a brief description of how they deal with this problem and the submission of forms ("a picture is equal to 1000 words") will be specially helpful.

Binding Reports

There are two types of report binding in use, one a "paper fastener" variety which permits the easy removal of sheets, the second a binding which must virtually be torn apart. The question, patently, is whether the first type is dangerous.

Readers' views on this subject are solicited and unusual experiences, for presentation in this column, will be particularly welcome.

The Selection of an Accountant

The American Institute of Management, New York, published a list of ten guides for management in the selection of an accountant. These rules were prepared after a survey of the practices followed by 298 concerns rated as excellently managed. Though it appears that companies of larger than average size were surveyed, including publicly-owned corporations, the list of guides nevertheless has broad interest.

Briefly, the ten points are the following:

1. The auditor should have an established reputation and be highly regarded.

2. A company having widespread branches should seek a firm which has regional offices, to achieve an economy in time and fees. Though not specified, the use of correspondents might satisfy some, if not all, prospective clients.

3. The auditor should have high professional standing, personal integrity, and adhere to the accountant's Code of Ethics.

4. Consideration should be given to the auditor's contributions to the accounting profession.

5. The auditor's participation in civic affairs should be of a proper nature and in the public interest.

6. The company should check the auditor with their bank, attorney and investment counsel, if any.

7. It should be obvious that the auditor has kept abreast of current conditions.

8. It should be known whether the prospective auditor serves other companies in the same field.

9. In some fields, because of their technical nature, the use of a specialist is desirable.

10. As to publicly owned companies, the auditor should be selected by, or with the approval of the members of the Board of Directors who are not directly members of the management group.

(Continued on page 638)

The Excess Profits Tax Exchange

Conducted by David Zack, C.P.A.

This department is a clearing house for questions, problems, comments and rulings, regarding Excess Profits Taxes. We are especially interested in special and informal rulings on Excess Profits Taxes. All items of general interest will be published herein and full credit will be given all contributors unless they request otherwise. All inquiries and contributions should be addressed to:

Editor, The Excess Profits Tax Exchange
The New York Certified
Public Accountant
677 Fifth Avenue
New York 22, N. Y.

Effect of Tax Assessments

M. J. Feingold, C.P.A., submits the following very practical question:

> "What effect might an assessment of additional federal income taxes, for a year ending after June 30, 1950, have on excess profits taxes paid by a corporation under the following circumstances:
>
> a—where the assessment was due to the capitalization of expenses deducted, resulting in an increased net worth;
>
> b—where the assessment was due to the disallowance of deductions claimed and resulted in a decrease in net worth by reason of an increased liability for Federal taxes.
>
> What would be the practical way to handle refunds accruing by reason of these audits for other years?"

This column has previously discussed the effect of Revenue Agents' examinations of taxable years encompassed by the corporate base period. This question carries the problem a step further and relates the issue to taxable years ending after June 30, 1950, the effective date of the Excess Profits Tax Act.

An assessment resulting from the capitalization of expenses, which would, of course, cause an increase in net worth, would serve to increase the net capital addition for the current year and would therefore tend to decrease the corporation's excess profits tax liability. The same result would ensue in the case of a taxpayer which used the invested capital method inasmuch as the net worth of a corporation on which the increase is based would be increased. The opposite effect would result when the revenue agent's examination results in a decrease in net worth due to an increased liability for Federal taxes without a concomitant increase in other assets.

As a practical matter it would seem that, except for unusual cases, the excess profits tax adjustments which would flow as a result of federal tax assessments for excess profits tax years should be left for future revenue agents' examinations rather than serve as a basis for claims for refund.

David Zack, C.P.A. and member of the Bar, is a member of our Society and of its Committee on Federal Taxation. He is Chairman of the Committee on Municipal and Local Taxation.

Mr. Zack is a Lecturer on Taxation at The City College (N. Y.) School of Business and Civic Administration and at the New York University Institute on Federal Taxation.

Mr. Zack has written on tax matters for various publications. He is a partner in the firm of David Berdon & Co., Certified Public Accountants.

Ruling on Election of Historical Invested Capital

Many practitioners have been concerned about the possibility that failure to file an excess profits tax return because a corporation showed less than $25,000.00 excess profits net income in a particular year might deprive the taxpayer of its right to elect the use of the historical invested capital method under Section 458 of the I.R.C. A recent ruling by the Bureau of Internal Revenue makes it clear that this fear is unfounded. The ruling, I.T. 4087, 1952-13-13848 (p. 20) should be of sufficient interest to warrant reproduction in full.

"Advice is requested whether a taxpayer which did not file Schedule EP of Form 1120 because it had less than $25,000 excess profits net income in a particular taxable year may subsequently compute its excess profits credit for that year by use of the historical invested capital method under section 458 of the Internal Revenue Code for the purpose of determining the amount of any unused excess profits credit carry-back or carry-over to a preceding or subsequent year.

"Section 437(b)(1) of the Internal Revenue Code provides in part as follows:

'(1) Election of Taxpayer—The invested capital for any taxable year shall be the adjusted invested capital determined under paragraph (2) (of section 437(b) of the Code), except that if the taxpayer elects in its return for such taxable year to compute its invested capital under the provisions of section 458, the invested capital for such year shall be the historical invested capital determined under section 458.***'

"Section 40.437-2(c) of Regulations 130 provides in part as follows:

'(c) Election to use historical invested capital.—If the taxpayer * * * elects on its return for the taxable year to compute its invested capital under the provisions of section 458, the invested capital of the taxpayer for such year shall be the historical invested capital determined under section 458.

'A separate election must be made for each taxable year, and an election once made is irrevocable with respect to the taxable year. A taxpayer making such election may not thereafter compute invested capital for the taxable year under section 437(b)(2). If the historical method is used on the return in determining the excess profits tax liability, the taxpayer will be deemed to have elected the historical method. A taxpayer which computes its excess profits tax on its return on the basis of a credit other than the invested capital credit may nevertheless elect the historical method for such year, in the event that the invested capital credit should subsequently become significant in the determination of its excess profits tax liability for such year, by attaching to its return for the taxable year a statement electing the historical method.'

"It is held that where a taxpayer did not file Schedule EP of Form 1120 because it had less than $25,000 excess profits net income in a particular taxable year, it may exercise at a later date the election provided by section 437(b)(1) of the Internal Revenue Code and compute its invested capital for such year under section 458 of the Code for the purpose of determining the amount of any unused excess profits credit carry-back or carry-over to a preceding or subsequent year."

Office and Staff Management

(Continued from page 636)

Demonstration of Duplicating Machine

Because of the unusual interest of accountants in machines for the reproduction of tax returns, financial statements, and other material, the Committee on Administration of Accountants' Practice has arranged for a demonstration of a photographic and an offset type of machine at a technical meeting to be devoted to this subject. The meeting will be held at the Engineering Auditorium (39th Street between Fifth and Sixth Avenues) on November 6, 1952 at 7:00 p.m.

BOOK REVIEWS

(Continued from page 585)

After developing the fundamental principles and considerations in compiling standards, the author discusses and presents three distinct methods of operating standard costs. He specifically provides practical application to actual situations. Each of the three methods is carried through independently, from the basic principles to the preparation of a final report for executives. Among the additional subjects treated are: gross profit variances; distribution costs, including methods of allocation and grouping plus methods with examples in analyzing distribution costs. In other sections he discusses budgeting profits for various levels; break-even point; handling of scrap, known or unknown; efficiency ratios and transfer charges. These and many other topics are explained, illustrated and applied in a manner which is comprehensible to the reader.

The four case studies represent the product of an intensive study coupled with practical experience gained by the author in specific organizations. Following the presentation of introductory data, each case is thoroughly discussed so as to show the principles involved and the methods employed in reaching a solution.

Case 1 deals with the establishment of physical and standard costs in assembly production techniques for an enterprise engaged in the manufacture of electrical equipment and cable.

Case 2 deals with reports on industrial labor and spending performance relating to an organization engaged in producing electrical goods for household use and public utilities.

Case 3 deals with inventory control, presenting actual and standard costs. He incorporates material on the handling of scrap, efficiency ratios and transfer charges in connection with inventory valuation.

Case 4 concerns itself with costs of catalog and magazine printing, setting forth the methods of estimating, budgeting, developing machine rates, preparing daily effectiveness reports, departmental expense reports and weekly as well as monthly manufacturing reports.

In the opinion of the reviewer, this book, with its wealth of discussion and illustrative presentation, should be well accepted as a thorough treatise in the field of Standard Cost Accounting.

Leo Schloss

Long Island University
Brooklyn, N. Y.

MAPI Accounting Manual

Machinery and Allied Products Institute, Chicago 3, Ill., 1952. Pages: xi + 169; $15.00.

This manual (a revision of a previously published work) is intended primarily for financial officers and other corporate executives in the capital goods industries. It summarizes for these executives current accounting concepts, conventions and problems, especially as they apply to the capital goods industries (e.g., machine tool builders, steel foundries, locomotive and electrical equipment manufacturers), and also explains to them the increased importance of accounting to corporate management.

Included in this manual are sections on:

Classification and Description of Accounts
Financial Statements and Reports
Property, Plant and Equipment
Manufacturing Cost
Sales Engineering and Administrative Expenses
Pensions
Internal Control and Auditing
Cost Estimating and Its Uses
Profit Planning and Budgeting
Recognition of Changing Value of Dollars

The first section, devoted to Classification and Description of Accounts, comprises approximately one-third of the Manual. Included therein is an outline of the general ledger chart of accounts together with an outline of the accounts to be included in the subsidiary ledgers for Factory Expenses, Sales Engineering Expenses, Administrative Expenses and Engineering Expenses. The illustrative chart of accounts is sufficiently flexible to permit its adaptation to either a standard cost, job order cost, or process cost accounting system.

Among the accounts provided for in the Chart of Accounts is a group referred to as "Equalization Accounts." This group is intended to equalize over the current year expenses that are incurred disproportionately at times during the year, and are of such magnitude that to charge them to operations in the period in which incurred would distort the periodic operating results. Examples of such equalization accounts include Vacations and Holidays, and Social Security Taxes (because of the heavier burden during the early part of the year resulting from the $3,000 or $3,600 limits).

The section relating to manufacturing costs discusses the three principal methods for de-

(Continued on page 640)

BOOK REVIEWS

(Continued from page 639)

termining factory cost of sales (job order, standard and process costs) and also summarizes the various assumptions for inventory pricing (FIFO, LIFO, Normal or Base Stock, and Retail) followed by a discussion of the revaluation of inventory where current market price is below cost as determined by one of the assumptions previously enumerated.

The inclusion of sections on Pensions and Recognition of Changing Value of Dollar indicates the increased significance attached to these two subjects. Both of these sections are limited to generalized statements of the nature of the problems; the bibliography, however, makes reference to more than 25 articles dealing with the impact of rising prices on financial reporting.

This reviewer hopes that a supplement to this Manual will discuss in detail the special accounting problems and practices incidental to the renegotiation of contracts with government agencies.

The Manual is a well organized work; wherever appropriate charts and illustrative statements are presented to facilitate the understanding of the material contained in the text.

This work is recommended for inclusion in the accountant's library. From a study of this manual the practitioner can obtain an excellent understanding of the operations of a cost accounting system together with the reports which may be based thereon; also, from this MAPI Accounting Manual the public accountant may obtain added familiarity with the thinking of industrialists insofar as it relates to current accounting concepts, conventions and practices.

ABRAHAM J. BRILOFF

New York, N. Y.

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